83-950

No. 83-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

MICHAEL E. MOSS,

Petitioner,

v.

JAMES M. NEWMAN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED

1. Did the Court of Appeals err in concluding that a misappropriation of material nonpublic information does not give rise to a private claim for relief under Section 10(b) of the Securities Exchange Act of 1934 by sellers of securities against purchasers who bought on the basis of the misappropriated information?

PARTIES TO THE PROCEEDING BELOW

Petitioner and plaintiff-appellant below is Michael E. Moss. Respondent and defendant-appellee below is James M. Newman. Morgan Stanley, Inc. was also a defendant and an appellee but is not made a respondent in this petition. Adrian Antoniu and E. Jacques Courtois, Jr., were also named as defendants in the district court.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Michael E. Moss prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this case.

OPINIONS BELOW

The United States Court of Appeals for the Second Circuit affirmed dismissal of petitioner's complaint brought pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("Exchange Act"), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, for damages suffered as a result of respondent Newman's trading in securities on the basis of misappropriated material nonpublic information. The opinion of the Court of Appeals has not been officially reported. It is reported at [Current] CCH Fed. Sec. L. Rptr. ¶ 99,478 (2d Cir. 1983). It is set forth in the Appen-

dix ("App.") at 1a-36a. The opinion of the United States District Court for the Southern District of New York is reported at 553 F. Supp. 1347 (S.D.N.Y. 1983) and is set forth at App. 37a-65a.

JURISDICTION

Jurisdiction to review the September 9, 1983 decision of the Court of Appeals is vested in this Court by 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities Exchange Commission ("S.E.C."), 17 C.F.R. § 240.10b-5, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

This case presents, in a civil context, the "misappropriation" issue expressly left undecided by this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980)—namely, whether liability may be based upon the misappropriation by an individual and two co-conspirators of material non-public information concerning unannounced tender offers, which was used by the conspirators to trade in securities of the companies involved for their own pecuniary benefit.[1]

This action was brought following the indictment, trial and criminal conviction in July 1982 of respondent, James M. Newman, before the United States District Court for

[1] In his dissent in *Chiarella* which involved a criminal conviction, Chief Justice Burger argued for the adoption of the "misappropriation" theory of liability. 445 U.S. at 239-245. Justice Brennan, in his concurring opinion, agreed with the theory, but found that it had not been presented to the jury. 445 U.S. at 239. Justice Blackmun, with whom Justice Marshall joined in dissent, agreed with much of what the Chief Justice stated about the "misappropriation" theory. 445 U.S. at 245. Justice Powell, writing for the Court, specifically held that, since the "misappropriation" theory had not been presented to the jury, it would not be considered. 445 U.S. at 235-236. Justice Stevens, in his concurring opinion, agreed that the issue should not be addressed in the circumstances presented. 445 U.S. at 238.

the Southern District of New York, of conspiracy, seven counts of violations of Section 10(b) and Rule 10b-5 (including one count involving the identical transaction presented in this action), and seven counts of mail fraud.[2] Newman, a former stockbroker, was sentenced to a term of imprisonment of one year and a day and fined $10,000. His conviction was affirmed by the Second Circuit Court of Appeals. *United States* v. *Newman*, Docket No. 82-1273, Order dated 2/8/83; *certiorari* was recently denied by this Court, 52 U.S.L.W. 3227 (Oct. 3, 1983).

This action was commenced in August 1982 by petitioner Michael E. Moss on his own behalf and on behalf of a class of persons who sold shares of Deseret Pharmaceutical Company ("Deseret") stock on November 30, 1976. The Amended Complaint alleges that the individual defendants, Newman, Antoniu and Courtois[3], undertook and carried on a scheme and conspiracy to trade in the securities of various companies on the basis of material nonpublic information concerning proposed tender offers, all in violation of Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)), and Rule 10b-5 promulgated thereunder (17 C.F.R. § 240.10b-5).

Defendants were specifically charged with purchasing Deseret stock on November 30, 1976 after acquiring knowledge of the imminent joint announcement of a tender offer for Deseret shares by Warner-Lambert Com-

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[2] Initially, the district court dismissed the indictment against Newman, but the Second Circuit reversed. *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981).

[3] Antoniu had pled guilty to a criminal information based upon his role in the scheme, and was sentenced to a three month term of imprisonment. Courtois, who was indicted with Newman, was a fugitive who has recently been extradited to the United States.

pany ("Warner-Lambert"). This knowledge was acquired by Courtois as an employee in the mergers and acquisitions department at Morgan Stanley, Inc., an investment bank retained to evaluate the proposed transaction. Courtois passed this information to Antoniu (a former Morgan Stanley employee), who, pursuant to the conspiracy, instructed Newman to purchase Deseret shares immediately. Subsequently, the tender offer at a premium was announced and the conspirators reaped a handsome profit.

The Deseret transaction was not the first one of this kind for these conspirators. At Newman's criminal trial Antoniu testified at length concerning the formation and conduct of their scheme. In fact, the "leak" about Deseret was only one in a series of similar transactions extending over a period in excess of three years.

Early in 1973, Antoniu, who was then employed in the coporate finance department of Morgan Stanley, and Newman, a broker-dealer, resolved to form a "partnership." In brief, Newman was to supply capital and make investments in stocks "recommended" by Antoniu. These recommendations, however, were based upon nonpublic information learned by Antoniu in the course of his employment at Morgan Stanley of proposed tender offers prior to their public announcement. When the offers were announced, the market price of the target company's stock would rise, and Newman would sell his shares, splitting the profits with Antoniu.

This pact was first tested in 1973 with a stock known as Certainteed. Antoniu learned through his employment at Morgan Stanley, that a company known as Saint Gobain Pont Mousson was considering a tender offer for controlling ownership in Certainteed. Thereafter, a public announcement of the Saint Gobain tender offer for Certain-

teed was made. Newman sold the stock at a considerable profit.

Later in 1973, Antoniu learned, during the course of his employment at Morgan Stanley, of a proposed takeover of a company named Funk Seeds by Ciba/Geigy. Morgan Stanley was acting as investment banker in the transaction. As before, Antoniu instructed Newman to buy shares of the target, which were sold at a profit after the announcement of the tender offer.

Throughout the spring and summer of 1974, Noth American Phillips Company was considering a tender offer for all of the shares of Magnavox. Antoniu learned of this situation during the course of his employment at Morgan Stanley and instructed Newman on several occasions to purchase Magnavox stock. A tender offer was announced at $8 per share, but Antoniu told Newman to hold the shares pending a later announcement. Shortly thereafter, there was a second announcement which increased the offering price to $9 per share. Newman then sold the Magnavox stock at a profit.

In the fall of 1974, Antoniu learned during the course of his employment at Morgan Stanley of a proposed tender offer by Standard Oil of Indiana for all of the shares of Occidential Petroleum. He followed the progress of this proposal and instructed Newman to purchase Occidental stock on several occasions. When the tender offer was announced, the price of Occidental stock increased and Newman sold his shares. The conspirators realized a profit although the takeover attempt was ultimately unsuccessful.

In December 1975, Antoniu was told that his services were no longer required at Morgan Stanley. In May 1976, he was employed by Kuhn Loeb & Co., Inc. in its mergers and acquisitions department.

In the interim, Antoniu recruited defendant Courtois, who was employed in the mergers and acquisitions department of Morgan Stanley, to join the scheme. Thenceforth, when Courtois learned of proposed takeovers, he passed the information to Antoniu, who in turn instructed Newman to purchase shares of the various target companies. Profits on those transactions were split three ways.

Courtois' first contribution to the scheme was a tip in 1975 to buy Pan Ocean Oil stock, based upon information that he obtained at Morgan Stanley of an impending takeover attempt. He contacted Antoniu who instructed Newman to buy the shares. Thereafter, in April 1976, Marathon Oil Company announced a tender offer for all of Pan Ocean at a price of $18 per share. Newman sold the stock and the profits were split among the conspirators.

In early 1976, Courtois learned during his employment at Morgan Stanley that a company known as Ventron was a target and tipped this information to Antoniu. As before, Antoniu told Newman to buy. Thereafter, a tender offer for Ventron by a foreign buyer was announced and the stock was sold at a profit.

In the summer of 1976, Courtois learned during the course of his employment at Morgan Stanley that Northrup King was the target of Sandoz. He tipped this information to Antoniu and urged that an immediate purchase of Northrup King stock be made. Newman bought 10,000 shares at $9½—10 per share and sold them at a profit after the tender offer was announced. However, there were certain antitrust problems in connection with the takeover. Courtois later told Antoniu that these problems had been resolved and that another purchase should be made. At Antoniu's direction, Newman again bought Northrup King stock. Soon thereafter a public announce-

ment was made that the antitrust obstacle had been overcome and that the tender price was $19.40 per share. Again, Newman sold, realizing a second profit on the same takeover.

The conspirators' next transaction concerned the negotiated takeover of Deseret by Warner-Lambert, the transaction at issue here. The criminal transcript indicates that Deseret and Warner-Lambert had, over some months, discussed the acquisition by Warner-Lambert of all of the outstanding shares of Deseret through a tender offer. Morgan Stanley was retained by Warner-Lambert on or about November 23, 1976 to evaluate the desirability of such a negotiated acquisition and to recommend an appropriate price per share for the tender offer.

During the course of this evaluation, representatives of Morgan Stanley apparently met directly with representatives of Deseret, and Morgan Stanley received information directly from officers of Deseret.[4]

On or about November 30, 1976, Courtois contacted Antoniu and informed him of the upcoming tender by Warner-Lambert for Deseret stock. Antoniu immediately telephoned Newman who purchased a substantial amount of Deseret shares at about $28 per share. It was on that day that plaintiff Moss and the class, unaided by foreknowledge of the tender offer, sold their Deseret shares.[5]

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[4] In fact, a Morgan Stanley list of the participants in "Project Cross" (Morgan Stanley's code name for the transaction between Warner-Lambert and Deseret) includes several Deseret officers.

[5] On November 30, 1976, 143,000 shares of Deseret stock were traded on the New York Stock Exchange. In contrast only 5,000 shares were traded on November 29, 1976.

On December 1, 1976, one day later, trading in Deseret shares was suspended at Deseret's request and was not resumed until after the announcement on December 7, 1976 of the offer, at a price of $38 per share, by Warner-Lambert for Deseret stock. Subsequently, Newman tendered his shares and reaped a substantial profit.

The Amended Complaint seeks damages from the individual defendants as a result of their violation of Section 10(b) of the Exchange Act and Rule 10b-5 in connection with the Deseret transaction.

In September 1982, defendant Newman moved to dismiss the Amended Complaint for failure to state a claim under Rule 12(b)(6), Fed.R.Civ.P. Shortly thereafter (October 1982), and before issued was joined, defendant Morgan Stanley filed its motion to dismiss under Rule 12(b)(6), or for summary judgment under Rule 56, Fed.R-.Civ.P.

The District Court granted defendants' motions by decision dated January 10, 1983, holding, *inter alia*, that: (1) plaintiff could not state a claim against Newman under the securities laws relying on *Chiarella* v. *United States*, 445 U.S. 222 (1980); and (2) plaintiff could not state a claim against, and that summary judgment should be granted for, Morgan Stanley upon the theories of liability proffered. App. 37a-65a.

The Second Circuit affirmed the dismissal of the Amended Complaint. The Court held that the individual defendants owed no duty to Moss and the selling shareholders because the information had not come from insiders of Deseret (App. 20a):

> The defendants in this case—Courtois and his tippees Antoniu and Newman—owed no duty of disclosure to Moss. In working for Morgan Stanley,

> neither Courtois nor Newman was a traditional 'corporate insider,' and neither had received any confidential information from the target Deseret. Instead, like Chiarella and Dirks, the defendants were 'complete stranger[s] who dealt with the sellers [of Deseret stock] only through impersonal market transactions.' *Chiarella* v. *United States*, 445 U.S. at 232-33.

The Second Circuit also rejected petitioner's argument, based upon the Chief Justice's dissent in *Chiarella*, that the misappropriation of nonpublic information by the individual defendants is sufficient for the imposition of liability under Section 10(b) and Rule 10b-5 (App. 22a-23a):

> In effect, plaintiff's 'misappropriation' theory would grant him a windfall recovery simply to discourage tortious conduct by securities purchasers. . . .
>
> * * *
>
> We find that plaintiff's 'misappropriation' theory clearly contradicts the Supreme Court's holding in both *Chiarella* and *Dirks* and therefore conclude that the complaint fails to state a valid section 10(b) or rule 10b-5 cause of action.

REASONS FOR GRANTING THE WRIT

1. The Decision Below Rejects The Logical Application Of The "Misappropriation" Theory As Set Forth In The *Chiarella* Dissent And Improperly Denies A Private Claim For Damages In A Civil Case Against Those Whose Criminal Liability For The Same Conduct Has Already Been Established

This petition presents, in a private civil action context, the "misappropriation" issue expressly left undecided in

Chiarella v. *United States*, 445 U.S. 222 (1980).[6] This Court in *Chiarella* held that mere possession of nonpublic information does not give rise to a duty to disclose or abstain, and that under the circumstances presented, there was no duty to disclose where the person trading on inside information "was not [the corporation's] agent . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." *Chiarella*, 445 U.S. at 232, 235.

The majority in *Chiarella* noted the alternative argument offered by the United States to support Chiarella's conviction:

> It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation. The breach of this duty is said to support a conviction under § 10(b) for fraud perpetrated upon both the acquiring corporation *and the sellers*. (emphasis added).

445 U.S. at 235-36. The Court specifically stated that it:

> need not decide whether this theory has merit for it was not submitted to the jury.
>
> * * *
>
> [W]e will not speculate upon whether such a duty existed, whether it has been breached, or whether such a breach constitutes a violation of § 10(b). [footnote omitted]

445 U.S. at 236-37.

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[6] This "misappropriation" theory is defined by Chief Justice Burger in his dissent in *Chiarella* (445 U.S. at 240):

> . . . a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.

This so-called "misappropriation" theory was discussed by Chief Justice Burger in his dissent in *Chiarella.* He found that the general rule of disclosure which is premised on the existence of a fiduciary or confidential relationship "should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means." 445 U.S. at 240. As he explicitly stated:

> I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.

445 U.S. at 240.

Justice Brennan, who concurred in the majority opinion because he believed the "misappropriation" theory had not been presented to the jury, expressed his agreement with the theory. 445 U.S. at 239.[7] Justice Stevens, who also concurred in the majority opinion, noted that the Court correctly did not address the "misappropriation" theory and that respectable arguments could be made in support of either position. 445 U.S. at 238. He further stated: "I think the Court wisely leaves the resolution of

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[7] Further, in the dissenting opinion of Justice Blackmun, joined by Justice Marshall, which rejected the reasoning of the majority, it was noted that they agreed with much of what was said in that part of Chief Justice Burger's dissenting opinion that adopted the "misappropriation" theory. 445 U.S. at 245. As Justice Blackmun stated:

> The fact that petitioner Chiarella purloined, or, to use the Chief Justice's word, ante, at 245, 63 L.Ed.2d, at 367, 'stole,' information concerning pending tender offers certainly is the most dramatic evidence that petitioner was guilty of fraud.

445 U.S. at 245-46.

this issue for another day." *Id.* We respectfully urge that this day is now at hand. This petition seeks a determination of the validity of the "misappropriation" theory in a private civil damage action under § 10(b) of the Exchange Act. The application of the "misappropriation" theory as set forth in *Chiarella* requires resolution in the context of a private civil action for damages by sellers of securities against persons who purchased the same securities based on misappropriated material nonpublic information.[8] This issue has a significant impact on the fair and efficient operation of the securities markets, the confidence and integrity investors have in those markets, and the ability of investors to recover damages against those who misuse information for their own pecuniary benefit.

The validity of the "misappropriation" theory has been questioned in the criminal context, with the Second Circuit having found the theory applicable. *United States* v. *Newman*, 664 F.2d 12 (1981). Commentators have written extensively on the "misappropriation" theory, some raising questions as to its rationale and application. *See, e.g.*, Note, *Trading on Confidential Information—Chiarella Takes an Encore: United States* v. *Newman*, 56 St. John's L. Rev. 727 (1982); Recent Developments, 27 Vill. L. Rev. 1329 (1982). One securities lawyer recently wrote that the rationale of *Dirks* v. *SEC*, 77 L.Ed. 2d 911 (1983) squarely contradicts the "misappropriation" theory. *See* Phillips, *Insider Trading Liability After Dirks*, Vol. 16, Review of Securities Regulation 841, September 28, 1983. *But see* Langevoort, *Insider Trad-*

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[8] Under this Court's decision in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), petitioner and the class of *sellers* he seeks to represent, are the only persons with standing to pursue a claim for damages under Section 10(b).

ing and the Fiduciary Principle: A Post-Chiarella Restatement, 70 Cal. L. Rev. 1, 52 (1982) (misappropriation theory would bring the law back close to the fairness-based theories that began the federal law of insider trading, while avoiding an *ad hoc* approach to determining liability). The issue presented here needs resolution, especially since much of the present focus of securities law regulation revolves around insider trading and its impact on the marketplace.

Adoption of the "misappropriation" theory is necessary to avoid a breach of the protections offered by and the very purposes of the Federal securities laws. Without adoption of this theory, persons in the shoes of Newman and Newman's cohorts in the massive fraudulent scheme described above, and even more vividly by the Second Circuit in *United States* v. *Newman, supra,* 664 F.2d at 117 (conduct of the "connivers" who "purloined" confidential information), would be immunized from civil liability. The holding of the Court below effectively permits those like Newman who have no direct relationship with the company whose shares are traded, to profit by trading on stolen information. Many persons could unjustly enrich themselves at the expense of investors who participate in and rely on the integrity of the marketplace.[9] Such a

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[9] The ability of such persons to unjustly enrich themselves is a paramount concern because it defeats one of the basic purposes of the antifraud provisions of the Federal securities laws—"to assure that dealing in securities is fair and without undue preference or advantages among investors" HR Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 91 (1975), *Chiarella, supra,* 445 U.S. at 241 (dissent of Chief Justice Burger). As the Chief Justice recognized, trading on the basis of misappropriated nonpublic information "quite clearly serves no useful function except [the trader's] own enrichment at the expense of others." 445 U.S. at 241. The "others" include investors like petitioner who are trading in the market with the expectation that there is not undue preference or advantages among investors.

result would undermine the efficiency and fairness of the Federal securities laws—and would remove a large element of investor trust and confidence in the integrity of the securities markets. *See* Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 334-337 (1979).

Limitation of the "misappropriation" theory to the criminal context would be an overly restrictive and improper interpretation of the antifraud provisions of the Federal securities laws whose essential purposes, as this Court has repeatedly recognized, are to protect investors. *See, e.g., Herman & MacLean* v. *Huddleston*, ___ U.S. ___, 103 S.Ct. 683, 692, 74 L.Ed.2d 548, 561 (1983); *United States* v. *Naftalin*, 441 U.S. 768, 774 (1979); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 (1976). *See also In re Cady Roberts & Co.*, 40 SEC 907, 910-11 (1961).

The "misappropriation" theory espoused by Chief Justice Burger in *Chiarella* rests on the premise that a person misappropriating nonpublic information has an absolute duty to disclose that information prior to trading or to refrain from trading. The duty to disclose is owed to shareholders and public investors. *See, Dirks* v. *SEC*, 77 L.Ed.2d 911, 929 (1983); *In re Cady Roberts & Co.*, 40 SEC 907, 911, 913-14 (1961). It is those public investors who sustained injury as a result of Newman's trading, and for whom a private cause of action is implied under Section 10(b)—both to compensate those persons injured by fraud and to augment the enforcement mechanisms of the Federal securities laws. *Herman & MacLean* v. *Huddleston, supra*, ___ U.S. ___, 103 S.Ct. at 689-90, 692, 74 L.Ed.2d at 558-59, 561; *O'Connor & Associates* v.

Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1188 (S.D.N.Y. 1981).[10]

Petitioner Moss is a perfect example of an investor who has been damaged by Newman's trading on the basis of misappropriated material nonpublic information concerning the proposed tender offer. If the information Newman possessed had been disclosed to a reasonable investor, he or she would not have sold his or her Deseret shares at $28 per share but rather would have held those shares and exchanged them in the $38 per share tender offer. Petitioner's damages flow directly from the failure to disclose this material information. *See Shapiro* v. *Merrill Lynch Pierce Fenner & Smith, Inc.*, 495 F.2d 228, 238-41 (2d Cir. 1974). *O'Connor & Associates, supra*, 529 F. Supp. at 1186-88.

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[10] Further, liability for the misappropriation or conversion of information finds support in the proposed Federal Securities Code prepared by the American Law Institute under the direction of Professor Louis Loss. *See Chiarella, supra*, 445 U.S. at 242 n. 3 (dissent of Chief Justice Burger). The Code provides a civil cause of action to investors against those violating the insider trading provisions. See ALI Federal Securities Code § 1703 (Proposed Official Draft 1978).

CONCLUSION

For the reasons set forth above, *certiorari* should be granted to review the judgment of the Court of Appeals.

Respectfully submitted,

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APPENDIX

[CORRECTED COPY]

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 1281—August Term, 1982

(Argued May 19, 1983 Decided September 9, 1983)

Docket No. 83-7120

MICHAEL E. MOSS,

Plaintiff-Appellant,

—v.—

MORGAN STANLEY INC., E. JACQUES COURTOIS, JR., ADRIAN ANTONIU, and JAMES M. NEWMAN,

Defendants,

MORGAN STANLEY INC. and JAMES M. NEWMAN,

Defendants-Appellees.

Before:

MANSFIELD, MESKILL and KEARSE,

Circuit Judges.

Appeal from the judgment entered in the United States District Court for the Southern District of New York, Pollack, *J.*, granting defendants' motions to dismiss for failure to state a claim and motion for summary judgment on the grounds that (1) plaintiff's complaint failed to state a cause of action for damages under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), or rule 10b-5, 17 C.F.R. § 240.10b-5 (1982); (2) because the individual defendants were free from liability for securities fraud, their employer could not be held derivatively liable as a "controlling person" under section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1976); and (3) plaintiff's complaint failed to state a claim for damages under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961 *et seq.* (1976 & Supp. III 1979).

Affirmed.

RICHARD J. KILSHEIMER, New York, New York (Robert N. Kaplan, Kaplan, Kilsheimer & Foley, New York, New York, Herbert E. Milstein, Steven J. Toll, Kohn Milstein Cohen & Hausfeld, Washington, D.C., of counsel), *for Plaintiff-Appellant.*

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HENRY L. KING, New York, New York (Arthur F. Golden, James L. Kerr, Davis Polk & Wardwell, New York, New York, of counsel), *for Defendant-Appellee Morgan Stanley Inc.*

Daniel L. Goelzer, General Counsel, Jacob H. Stillman, Associate General Counsel, Rosalind C. Cohen, Assistant General Counsel, Paul Gonson, Solicitor, Robert Mills, Elliot M. Pinta, Securities and Exchange Commission, Washington, D.C., *Amicus Curiae.*

MESKILL, *Circuit Judge*:

This appeal spotlights two issues of significance for the litigation of federal securities fraud claims: (1) whether a shareholder who unwittingly sold stock of a "target" company on the open market prior to public announcement of a tender offer has a cause of action for damages under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) (the 1934 Act), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1982) promulgated thereunder against a person who purchased "target" shares on the basis of material nonpublic information which he acquired from the tender offeror's investment adviser; and (2) whether this same unwitting shareholder can recover treble damages under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961 *et seq.* (1976 & Supp. III 1979) (RICO), on the ground that he was injured by an unlawful "enterprise" conducting a

"pattern of racketeering activity" comprised of "fraudulent" securities transactions.

The district court held that the shareholder failed to state a cause of action under both the 1934 Act and RICO. We agree for the reasons stated below.

Affirmed.

BACKGROUND

The chain of events that culminated in this action began in the latter months of 1976 with tender offer discussions between Warner-Lambert Company (Warner) and Deseret Pharmaceutical Company (Deseret). On November 23, 1976 Warner retained the investment banking firm of Morgan Stanley & Co. Incorporated, a subsidiary of Morgan Stanley Inc. (Morgan Stanley), to assess the desirability of acquiring Deseret, to evaluate Deseret's stock and to recommend an appropriate price per share for the tender offer.

One of the individual defendants in this action, E. Jacques Courtois, Jr., was then employed by Morgan Stanley in its mergers and acquisitions department. In that capacity Courtois acquired knowledge of Warner's plan to purchase Deseret stock. On November 30, 1976 Courtois informed defendant Adrian Antoniu, an employee of Kuhn Loeb & Co., of the proposed tender offer and urged him to purchase Deseret stock. Antoniu in turn informed James M. Newman, a stockbroker, that Warner intended to bid for Deseret. Pursuant to an agreement with Antoniu and Courtois, Newman purchased 11,700 shares of Deseret stock at approximately $28 per share for his and their accounts. Newman also advised certain of his clients to buy Deseret stock.

Trading was active in Deseret shares on November 30, 1976, with approximately 143,000 shares changing hands. Michael E. Moss, the plaintiff in this action, was among the active traders, having sold 5,000 shares at $28 per share. On the following day, December 1, 1976, the New York Stock Exchange halted trading in Deseret stock pending announcement of the tender offer. Trading remained suspended until December 7, 1976 when Warner publicly announced its tender offer for Deseret stock at $38 per share. Newman and the other defendants tendered their shares to Warner and reaped a substantial profit.

On August 5, 1982 Moss commenced this action on his own behalf and on behalf of the class of investors who sold stock in Deseret on November 30, 1976.[1] He contended that "members of the class have been substantially damaged in that they sold Deseret stock prior to the public announcement of the Warner tender offer at prices substantially below that offered by Warner." J. App. at 11. The amended complaint stated three causes of action: (1) Moss sought to recover damages from Newman for allegedly violating section 10(b) of the 1934 Act and rule 10b-5 thereunder by purchasing Deseret shares with knowledge of the imminent tender offer and without disclosing such information to Deseret shareholders;[2] (2)

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1 The parties agreed to delay consideration of class certification until 30 days following the district court's disposition of defendants' 12(b)(6) motions. *Moss* v. *Morgan Stanley Inc.*, 82 Civ. 5182 (S.D.N.Y. Dec. 16, 1982) (stipulation and order).

2 In Count I of the amended complaint, Moss alleged that Courtois and Antoniu, as well as Newman, violated section 10(b) and rule 10b-5. Moss also alleged that all three individual defendants violated section 14(e) of the 1934 Act, 15 U.S.C. § 78n(e) (1976), and rule 14e-3, 17 C.F.R. § 240.14e-3 (1982). Judge Pollack found that the section 14(e) claim was without merit and plaintiff has not challenged this finding. Judge Pollack also dismissed the section 10(b) claim

Moss sought to recover damages from Morgan Stanley on the ground that as a "controlling person" under section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1976), Morgan Stanley should be derivatively liable for Courtois' wrongdoing;[3] and (3) pursuant to RICO, 18 U.S.C. § 1964(c) (1976), Moss sought to recover treble damages from Newman on the ground that he engaged in "at least two acts of fraud in connection with the purchase and sale of securities and as such represent a pattern of racketeering activity within the meaning of RICO."[4] J. App. at 11.

In September 1982 Newman moved pursuant to Fed. R. Civ. P. 12(b)(6) to dismiss the complaint for failure to state a claim upon which relief could be granted. Shortly thereafter, defendant Morgan Stanley filed a rule 12(b)(6) motion to dismiss, alternatively styled as a Fed. R. Civ. P. 56 motion for summary judgment, and also requested attorneys' fees and costs pursuant to Fed. R. Civ. P. 11. The United States District Court for the Southern District of New York, Pollack, *J.*, granted both defendants'

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against all defendants and plaintiff has appealed only from the dismissal of this claim against Newman.

3 Count 1 also alleged that Morgan Stanley was jointly and severally liable to appellant for aiding and abetting the primary violations. The district court dismissed this portion of Count 1 as well as the "controlling person" claim under section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1976). Plaintiff appeals only from the dismissal of the "controlling person" claim.

4 Count 2 also alleged that Morgan Stanley violated RICO. Judge Pollack dismissed the RICO claims against all defendants, but plaintiff appeals only from the dismissal of the claim against Newman.

In Count 3 of the complaint, plaintiff alleged that all of defendants' unlawful acts "constitute[d] violations of the applicable principles of common law fraud" and that defendant Morgan Stanley was "liable under the doctrine of *respondeat superior*." J. App. at 12. The district court dismissed this count and plaintiff has not appealed.

motions to dismiss, defendant Morgan Stanley's Rule 56 motion[5] and awarded costs to both defendants. *Moss* v. *Morgan Stanley Inc.*, 553 F.Supp. 1347, 1352 (S.D.N.Y. 1983). Although we disagree with several of the reasons advanced by the district court for dismissing plaintiff's RICO claim, we affirm the judgment dismissing the complaint and awarding costs to both defendants.[6]

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5 On September 21, 1982 the parties met with the district court at a pretrial conference and Morgan Stanley indicated its intention to file a motion for summary judgment. Judge Pollack specifically stated that before the hearing on this motion "the plaintiff would be afforded whatever discovery plaintiff deemed necessary to defend the amended complaint." 553 F.Supp. at 1364. Morgan Stanley provided plaintiff with extensive document discovery and repeatedly asked plaintiff to designate any witnesses for deposition. *Id.* Plaintiff did not designate anyone for deposition. Judge Pollack regarded plaintiff's lack of initiative as providing:

> fair inference in the circumstances on the basis of the affidavits submitted by Morgan Stanley and their challenging effect and the background of this case that discovery would demonstrate cogently the absence rather than the presence of genuine issues of material fact on either the securities claim or the RICO claim.

Id. Finding that plaintiff had failed to carry his burden, Judge Pollack granted Morgan Stanley's summary judgment motion. *Id.*; *see Beal* v. *Lindsay*, 468 F.2d 287, 291 (2d Cir. 1972).

Plaintiff appeals only from the district court's grant of summary judgment dismissing plaintiff's section 20(a) "derivative liability" claim. 15 U.S.C. § 78t(a) (1976).

6 Prior to this civil suit, on February 3, 1981, a 27 count criminal indictment charged Courtois and Newman with committing a series of criminal violations of 10(b) and rule 10b-5 (including trading on the Deseret tender offer information), as well as violations of the federal mail fraud and conspiracy statutes. *United States* v. *Courtois*, 81 Cr. 53 (S.D.N.Y. filed Feb. 3, 1981), *as superseded*, 82 Cr. 0166 (S.D.N.Y. filed Mar. 1, 1982). Newman was convicted on seven counts of securities fraud, seven counts of mail fraud and one count of conspiracy. He received a one year jail sentence and a fine of $10,000. *United States* v. *Newman*, No. 82-1273 (2d Cir. Feb. 8, 1983) (unpublished order affirming conviction), *petition for cert. filed*, 51 U.S.L.W. 3759 (U.S. Apr. 8, 1983).

Antoniu cooperated with the government and pled guilty to an Information based on his role in the securities scheme. He was sentenced to a three month term of imprisonment. Courtois, who was indicted with Newman, remains a fugitive from justice.

DISCUSSION

I. *Section 10(b) Liability*[7]

A. *Introduction*

It is well settled that traditional corporate "insiders"—directors, officers and persons who have access to confidential corporate information[8] must preserve the

[7] Section 10(b) of the 1934 Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1982). The duty to either disclose or refrain is traditionally based on subsection (c) of rule 10b-5. However the courts have never treated the subsections of rule 10b-5 as carrying different legal consequences. *See List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[8] Section 16(b) of the 1934 Act defines "insiders" as directors, officers and 10% beneficial owners. 15 U.S.C. § 78p (1976). However, there is no definitive test for defining an "insider." 3 A. Bromberg, Securities Law, § 7.4(6)(b) at 180-81 & n.169.1 (1969). This Court's initial

confidentiality of nonpublic information that belongs to and emanates from the corporation.[9] Consistent with this

characterization of an "insider" reaffirmed the SEC's view that anyone who has access to the issuer of stock and thereby obtains nonpublic information is an "insider" for purposes of the federal securities laws:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971) (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961)). Ordinarily, "insiders" include such corporate figures as directors and vice presidents, persons who have access to confidential corporate information and therefore owe a duty to a corporation's shareholders not to trade on that information. *See Dirks* v. *SEC*, 681 F.2d 824, 835 (D.C. Cir. 1982), *rev'd on other grounds*, 51 U.S.L.W. 5123 (U.S. July 1, 1983); *O'Connor & Assoc.* v. *Dean Witter Reynolds, Inc.*, 529 F.Supp. 1179, 1184-85 (S.D.N.Y. 1981); Langevoort, *Insider Trading and the Fiduciary Principle: A Post*-Chiarella *Restatement*, 70 Cal. L. Rev. 1, 19-24 (1982).

9 In addition to distinguishing between "insiders" and "outsiders" with respect to the "duty of disclosure" under section 10(b) and rule 10b-5, the courts and commentators have also distinguished between "inside" and "outside" information. "Inside" information generally concerns the internal business affairs of the issuer—assets and earning power. "Outside" or "market" information is "related solely to the market for the securities rather than their intrinsic value." *Dirks* v. *SEC*, 681 F.2d 824, 834 (D.C. Cir. 1982), *rev'd*, 51 U.S.L.W. 5123 (U.S. July 1, 1983).

In *Dirks* v. *SEC*, the D.C. Circuit discussed the importance of the "character" of information in determining whether non-disclosure of such information violates section 10(b) of the 1934 Act:

> On the one hand, some of the language in the cases finds the element of unfairness and fraud in conflicts of interest on the part of traders or their informants who profit at the expense or to the exclusion of those who have placed trust in them. The conflict of interest may arise from a traditional fiduciary relationship, as between a corporate director and the corporation's shareholders, or a similar relationship of trust, as between employers and employees or investment bankers and their clients. *On the other hand, some of the cases imply that the securities laws impose a duty to disclose or refrain from trading based on the nature of the undisclosed information.* The theory is that all investors should have equal access to

duty, the "insider" must either disclose nonpublic corporate information or abstain from trading in the securities of that corporation. *See SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971); *accord Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972) ("The essential purpose of Rule 10b-5 . . . is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders."). The individual defendants in this case—Courtois, Antoniu and Newman—having acquired confidential information

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> information that a reasonable investor would consider material to investment decisions, and that any trade in which only one party had an opportunity to learn and did learn such information is inherently unfair.

Id. at 835 (emphasis added) (footnotes omitted). The "[t]ension between the two theories derives in large part from the conflict between the two major ideals of the federal securities laws: fairness to all investors and efficient markets for capital." *Id.* at 835 n.14; *see* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 333-39 (1979).

This "information" theory of section 10(b) liability has been rejected by some commentators:

> The same information can therefore be either inside or outside information. A market researcher or columnist who concludes from published information that a certain company is ripe for a takeover bid, the person making the tender offer, an employee of the tender offeror who misuses the information, and even a stock market specialist or broker who observes preparations for the tender offer, all use outside market information when they trade in target securities. By contrast, the target executive who learns of the impending offer by virtue of his employment uses inside market information when he trades in target stock. ***The important factor is not the type of information***, so long as it is material, ***but its source.***

Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. Pa. L. Rev. 1307, 1309-10 n.11 (1981) (emphasis added), and most recently the Supreme Court has laid the issue to rest: "Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading: '[T]he 'information' theory is rejected.'" *Dirks* v. *SEC*, 51 U.S.L.W. 5123, 5126 (U.S. July 1, 1983).

through Warner's investment adviser and having no direct relationship with Deseret, could not be traditional corporate "insiders."

However, in a number of decisions the Supreme Court has extended the "duty of disclosure" requirement to nontraditional "insiders"—persons who have no special access to corporate information but who do have a special relationship of "trust" and "confidentiality" with the issuer or seller of the securities. *See, e.g., Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) (bank employees who purchased shares in a tribal trust fund from mixed-blood Ute Indians without disclosing that there was a secondary market for shares at higher prices among non-Indians); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (investment adviser who purchased stock for his own account just before publishing a recommendation that his clients buy the stock); *see also Zweig* v. *Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979) (financial columnist); *Lewelling* v. *First California Co.*, 564 F.2d 1277 (9th Cir. 1977); *Frigitemp Corp.* v. *Financial Dynamics Fund, Inc.*, 524 F.2d 275 (2d Cir. 1975); *Flynn* v. *Bass Brothers Enterprises*, 456 F.Supp. 484 (E.D. Pa. 1978). Moss sought to include the defendants in this category of nontraditional "insiders" and argued that they necessarily violated section 10(b) and rule 10b-5 by purchasing Deseret stock without publicly disclosing their knowledge of the impending tender offer. After finding that none of the defendants occupied a position of "trust" with respect to Moss, the district court held that none of the defendants owed him such a "duty of disclosure." In light of the Supreme Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and *Dirks* v. *SEC*, 51 U.S.L.W. 5123 (U.S. July 1, 1983), which recently articulated the standard for

analyzing violations of section 10(b) and rule 10b-5, we agree with the district court's dismissal of plaintiff's federal securities law claim.

B. Chiarella v. United States

In *Chiarella* v. *United States*, 445 U.S. 222 (1980), an employee of a New York financial printer deduced the identity of corporate takeover targets from the confidential offering documents prepared by his firm. Without disclosing his knowledge of the acquiring company's plans, Chiarella purchased stock in the target companies and sold it at a substantial profit immediately after public announcement of the takeovers. *Id.* at 224. He was indicted and convicted of violating section 10(b) of the 1934 Act and rule 10b-5. A divided Court of Appeals affirmed the conviction. *United States* v. *Chiarella*, 588 F.2d 1358 (2d Cir. 1978) (Meskill, *J.*, dissenting).

The Supreme Court reversed, stating that:

> In this case, the petitioner was convicted of violating § 10(b) although he was not a corporate insider and he received no confidential information from the target company. Moreover, the "market information" upon which he relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company. *Petitioner's use of that information was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading.*

Chiarella v. *United States*, 445 U.S. at 231 (emphasis added) (footnote omitted); *see Dirks* v. *SEC*, 51 U.S.L.W. at 5125. The Court explained that liability for nondisclosure of material nonpublic market information under section 10(b) is "premised upon a duty to disclose

arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230. Absent an "insider" or "fiduciary" relationship with the sellers of stock, a purchaser has no duty to disclose nonpublic market information. *Id.* at 229 (citing with approval *General Time Corp.* v. *Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) ("We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale.")); *see also Polinsky* v. *MCA Inc.*, 680 F.2d 1286, 1290 (9th Cir. 1982) ("[A] purchaser of stock who has no fiduciary relationship to the prospective seller of the stock and who owns less than five percent of the target companies' stock has no duty to disclose circumstances that will insure the purchaser pays the highest possible price for the stock."); *Staffin* v. *Greenberg*, 672 F.2d 1196, 1201-02 (3d Cir. 1982).

The Court concluded unequivocally that Chiarella owed no duty of disclosure:

> [T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

Chiarella v. *United States*, 445 U.S. at 232-33.

C. *Application of* Chiarella

In applying *Chiarella*'s "fiduciary standard" to this case, Judge Pollack concluded that Newman owed no "duty of disclosure" to plaintiff Moss and hence could not be liable for a section 10(b) or rule 10b-5 violation. 553 F.Supp. at 1352-53. We agree. Like Chiarella, both Courtois and Newman were "complete stranger[s] who dealt with the sellers [of Deseret stock] only through impersonal market transactions." *Chiarella* v. *United States*, 445 U.S. at 232-33. However, in this appeal plaintiff continues to insist, *arguendo*, that if civil "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction," then he occupied such a position of "trust" with respect to the defendants. He suggests three sources for the defendants' "duty of disclosure."

1. United States v. Newman

Moss first argues that because Courtois owed a "fiduciary duty" to his employer, Morgan Stanley, and to Morgan Stanley's client, Warner, then Newman (standing in Courtois' shoes) owed a separate duty of disclosure to Deseret shareholders. Plaintiff claims that our decision in *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, Docket No. 82-1273 (2d Cir. Feb. 8, 1983) (unpublished order), *petition for cert. filed*, 51 U.S.L.W. 3759 (U.S. Apr. 8, 1983), supports this circuitous linking of liability. We disagree.

In *Newman* we held that Courtois' and Antoniu's securities transactions constituted a breach of their fiduciary duty of confidentiality and loyalty to their employers (Morgan Stanley and Kuhn Loeb & Co., respectively) and thereby provided the basis for *criminal* prosecution

under section 10(b) and rule 10b-5. Indeed, the district court at Newman's trial specifically charged the jury that "the law is clear that Mr. Newman had no obligation or duty to the people from whom he bought the stock to disclose what he had learned, and, thus, he could not have defrauded these people as a matter of law." J. App. at 29-30. Nothing in our opinion in *Newman* suggests that an employee's duty to "abstain or disclose" with respect to his employer should be stretched to encompass an employee's "duty of disclosure" to the general public. In fact, we explicitly limited our holding in *Newman* by stating:

> In two instances the targets themselves were clilents of the investment banking firms. The Government belatedly suggests that the indictment should be construed to allege securities laws violations in these two instances, on the theory that the defendants, by purchasing stock in the target companies, *defrauded the shareholders of those companies*. Whatever validity that approach might have, it is not fairly within the allegations of the indictment, which allege essentially that the defendants defrauded the investment banking firms and the firms' takeover clients.

United States v. *Newman*, 664 F.2d at 15 n.1 (emphasis added). Thus, the district court was correct in concluding that "plaintiff cannot hope to piggyback upon the duty owed by defendants to Morgan Stanley and Warner. There is no 'duty in the air' to which any plaintiff can attach his claim." 553 F.Supp. at 1353.

2. "Insider" Trading

Plaintiff's next attempt to find a source for Newman's duty to disclose is to argue that Morgan Stanley and its

employee Courtois were "insiders" of Deseret and therefore owed a duty to Deseret shareholders. Moss asserts that Morgan Stanley and Courtois were transformed into "insiders" upon their receipt of confidential information from Deseret during tender offer negotiations in this "friendly takeover." Such an argument fails both as a matter of fact and law.

First, the complaint contains no factual assertions that Morgan Stanley or Courtois received *any* information from Deseret. Nor does it allege that Newman traded on the basis of information derived from the issuer or seller of Deseret stock. Rather, the complaint was premised solely on the theory that Newman traded on the basis of information originating from "Warner's plan to acquire Deseret stock." J. App. at 9.

Yet, even if we overlook the complaint's facial deficiencies, plaintiff's theory fails as a matter of law. In *Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980), we held that an investment banker, representing an acquiring company, does not owe a fiduciary duty to the target simply because it received confidential information during the course of tender offer negotiations. In *Walton*, Kennecott Copper Corporation retained Morgan Stanley to advise it about the possible acquisition of Olinkraft, Inc. In the course of negotiations, Olinkraft furnished Morgan Stanley with "inside" information which was to be kept confidential. Although Kennecott ultimately elected not to bid, Morgan Stanley purchased Olinkraft shares for its own account based on the "confidential" information. In rejecting Olinkraft's claim that Morgan Stanley violated section 10(b) by breaching a fiduciary duty owed to Olinkraft, we held that Morgan Stanley had engaged in arm's length bargaining with the target. Morgan Stanley did not become the target's fiduciary

simply upon receipt of confidential information. We noted that "we have not found any [cases] that consider[] one in Morgan Stanley's position [investment adviser to the "shark"] to stand in a fiduciary relationship to one in Olinkraft's [the target]." *Id.* at 799; *see Dirks* v. *SEC*, 51 U.S.L.W. 5123, 5127 n.22 (U.S. July 1, 1983) (citing *Walton* with approval as "[a]n example of a case turning on the court's determination that the disclosure did not impose any fiduciary duties on the recipient of the inside information"); *see generally Frigitemp Corp.* v. *Financial Dynamics Fund, Inc.*, 524 F.2d 275, 278-79 (2d Cir. 1975) (investment companies that traded on confidential information obtained in the course of negotiations for private placement of debentures owed no duty to the selling corporation).

Relying on *Walton*, Judge Pollack properly concluded that "unless plaintiffs can set forth facts that turn the negotiations from arm's length bargaining into a fiduciary relationship, they cannot claim that Morgan Stanley owed them a fiduciary duty." 553 F.Supp. at 1355. We recognize that with only "the complaint and the appellee's motion to dismiss, we do not have the benefit of findings of fact about whatever communication occurred between Olinkraft [Deseret], the potential target, and Morgan Stanley, the financial advisor to the potential acquirer: how the communication proceeded, what understandings were reached, what assumptions or expectations the trade's practice would justify." *Walton* v. *Morgan Stanley & Co.*, 623 F.2d at 798. Yet Moss' complaint is patently deficient. It is barren of any factual allegations that might establish a fiduciary relationship between Morgan Stanley and Deseret. The complaint shows only that Morgan Stanley was retained by Warner and represented Warner's interest in the tender offer negotiations

with Deseret. The district court correctly found that the complaint did not allege a section 10(b) or rule 10b-5 claim premised on Morgan Stanley's "insider" status.

3. *Broker-Dealer Duty*

Plaintiff's final attempt to establish a cognizable duty between himself and the defendants is to argue that Newman violated rule 10b-5 because as a registered broker-dealer he owed a general duty to the market to disclose material nonpublic information prior to trading. Moss relies on the District of Columbia Circuit's decision in *Dirks* v. *SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 51 U.S.L.W. 5123 (U.S. July 1, 1983), to support his argument. Such reliance is misplaced. In *Dirks*, the SEC censured a broker-dealer for tipping his clients about irregularities at Equity Funding Corporation of America before he publicly disclosed evidence of corporate fraud. The Circuit Court did not consider whether a broker-dealer's nondisclosure of nonpublic information gives rise to civil liability under section 10(b) or rule 10b-5. In fact, the D.C. Circuit made clear that a "private action for damages might raise questions of standing, causation, and appropriate remedy not pertinent [in *Dirks*]." 681 F.2d at 839-40 n.19. Moreover, in the Supreme Court's recent reversal of *Dirks*, the Court expressly declined to consider Judge Wright's "novel theory" that "Dirks acquired a fiduciary duty by virtue of his position as an employee of a broker-dealer." 51 U.S.L.W. at 5128 n.26. Therefore, neither the D.C. Circuit's nor the Supreme Court's decision in *Dirks* lends any support to the plaintiff's argument.

We find nothing in the language or legislative history of section 10(b) or rule 10b-5 to suggest that Congress intended to impose a *special duty of disclosure* on broker-

dealers simply by virtue of their status as market professionals. *Cf. Dirks* v. *SEC*, 681 F.2d 824, 840, 841 & n.21 (D.C. Cir. 1982) (Judge Wright reads the legislative history of the 1934 Act as providing that "securities professionals regulated by the Act would owe certain responsibilities to the public at large as well as to their clients."). Indeed, to impose such a duty "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." *Dirks* v. *SEC*, 51 U.S.L.W. at 5126 & n.17.

Moreover, in *Dirks* v. *SEC*, 51 U.S.L.W. 5123 (U.S. July 1, 1983), the Supreme Court expressly reaffirmed its holding in *Chiarella* that " '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.' " *Id.* at 5126 (quoting *United States* v. *Chiarella*, 445 U.S. at 232-33 & n.14). The Court reexamined this "duty of disclosure:"

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or *consultant working for the corporation* [Deseret's advisers], these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. *See SEC* v. *Monarch Fund*, 608 F.2d 938, 942 (CA2 1979); *In re Investors Management Co.*, 44 S. E. C. 633, 645 (1971); *In re Van Alystne, Noel & Co.*,

> 43 S. E. C. 1080, 1084-1085 (1969); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S. E. C. 933, 937 (1968); *Cady, Roberts*, 40 S. E. C., at 912. . . . *For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.*

Id. at 5125 n.14 (emphasis added).

The defendants in this case—Courtois and his tippees Antoniu and Newman—owed no duty of disclosure to Moss. In working for Morgan Stanley, neither Courtois nor Newman was a traditional "corporate insider," and neither had received any confidential information from the target Deseret. Instead, like Chiarella and Dirks, the defendants were "complete stranger[s] who dealt with the sellers [of Deseret stock] only through impersonal market transactions." *Chiarella* v. *United States*, 445 U.S. at 232-33.

Since Moss failed to demonstrate that he was owed a duty by any defendant, he has failed to state a claim for damages under section 10(b) or rule 10b-5.

D. *"Misappropriation" Theory of Disclosure*

In addition to arguing that he satisfied the *Chiarella* "duty to disclose" standard, Moss alternatively argues that the district court misread *Chiarella*. He contends that *Chiarella* establishes *only* that "a duty to disclose under § 10(b) does not arise from the mere possession of non-public market information." 445 U.S. at 235. Moss urges us to recognize an exception to *Chiarella* and allow a section 10(b) cause of action against any person who trades on the basis of nonpublic "misappropriated" information.

Both Moss and the SEC premise their "misappropriation" theory on Justice Burger's dissent in *Chiarella*:

> I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.

Id. at 240; *see id.* at 239 (Brennan, *J.*, concurring) ("a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities"). In essence, Moss' theory is that any person who "misappropriates" information owes a general duty of disclosure to the entire marketplace. He asserts that this Court's recognition of the "misappropriation theory" is necessary to effectuate the remedial purposes of the securities laws. *See generally Herman & MacLean* v. *Huddleston*, 51 U.S.L.W. 4099, 4101 (U.S. Jan. 24, 1983).

While we agree that the general purpose of the securities laws is to protect investors, the creation of a new species of "fraud" under section 10(b) would "depart[] radically from the established doctrine that duty arises from a specific relationship between two parties . . . [and] should not be undertaken absent some explicit evidence of congressional intent." *Chiarella* v. *United States*, 445 U.S. at 233. In speaking of the origins of the concept of "fraud" as embodied in the federal securities laws, the Supreme Court in *Chiarella* stated that:

> At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a trans-

> action commits fraud *only when he is under a duty to do so.*

Id. at 227-28 (emphasis added).

In effect, plaintiff's "misappropriation" theory would grant him a windfall recovery simply to discourage tortious conduct by securities purchasers. Yet, the Supreme Court has made clear that section 10(b) and rule 10b-5 protect investors against *fraud*; they do not remedy every instance of undesirable conduct involving securities. *Id.* at 232; *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 474-77 (1977). As defendants owed no duty of disclosure to plaintiff Moss, they committed no "fraud" in purchasing shares of Deseret stock.

Moreover, the Court has refused to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." *Chiarella* v. *United States*, 445 U.S. at 233. Rather, in *Chiarella* the Court stated that:

> [N]either the Congress nor the Commission ever has adopted a parity-of-information rule. . . .
>
> . . . .
>
> . . . *We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.* The contrary result is without support in the legislative history of § 10(b) land would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets. *Cf. Santa Fe Industries, Inc.* v. *Green*, 430 U.S. at 479.

Id. at 233, 235 (emphasis added) (footnotes omitted). We find that plaintiff's "misappropriation" theory clearly contradicts the Supreme Court's holding in both

Chiarella and *Dirks* and therefore conclude that the complaint fails to state a valid section 10(b) or rule 10b-5 cause of action.

II. *Morgan Stanley's Derivative Liability*

Plaintiff claims that pursuant to section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1976), Morgan Stanley is a "controlling person" who should be found derivatively liable for the unlawful securities violations committed by its employees. Section 20(a) provides:

> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1976). In considering this claim the district court noted initially that "[a]s the claims against the individuals have been dismissed, Morgan Stanley cannot be derivatively liable." 553 F.Supp. at 1356. We agree. Because the section 20(a) claim was correctly dismissed on this threshold ground, we need not review the case law defining section 20(a) derivative liability.

III. *RICO*

A. *Introduction*

In Count II of the amended complaint, plaintiff Moss alleged that defendant Newman's unlawful purchase and

sale of Deseret stock constituted a violation of RICO, 18 U.S.C. § 1962(c) (1976), thereby subjecting him to civil liability under 18 U.S.C. § 1964(c) (1976). The district court dismissed plaintiff's RICO claim on the grounds that the complaint failed to include several allegations "essential" to pleading a RICO claim. We affirm the district court's dismissal of the RICO count, but do not endorse the court's reasons for doing so.[10]

B. *Threshold Defect in the Complaint*

To state a claim for damages under RICO a plaintiff has two pleading burdens. First, he must allege that the defendant has violated the substantive RICO statute, 18 U.S.C. § 1962 (1976), commonly known as "criminal RICO." In so doing, he must allege the existence of seven constituent elements: (1) that the defendant (2) through the commission of two or more acts (3) constituting a "pattern" (4) of "racketeering activity" (5) directly or indirectly invests in, or maintains an interest in, or participates in (6) an "enterprise" (7) the activities of which affect interstate or foreign commerce. 18 U.S.C. § 1962(a)-(c) (1976). Plaintiff must allege adequately defendant's violation of section 1962 before turning to the second burden—*i.e.*, invoking RICO's civil remedies of treble damages, attorneys fees and costs. *See Bays* v. *Hunter Savings Association*, 539 F.Supp. 1020, 1023 (S.D. Ohio 1982). To satisfy this latter burden, plaintiff must allege that he was "injured in his business or

10 We recognize that in attempting to delineate the scope of "civil" RICO, the district court did not have the benefit of our decisions in *United States* v. *Mazzei*, 700 F.2d 85 (2d Cir. 1983), *cert. denied*, 51 U.S.L.W. 3841 (U.S. May 23, 1983), *United States* v. *Ivic*, 700 F.2d 51 (2d Cir. 1983), and *United States* v. *Bagaric*, 706 F.2d 42 (2d Cir. 1983), as well as the Seventh Circuit's well-reasoned decision in *Schact* v. *Brown*, Docket No. 82-2088, slip op. (7th Cir. Apr. 8, 1983).

property *by reason of* a violation of section 1962." 18 U.S.C. § 1964(c) (1976) (emphasis added). Moss' complaint fails to carry either pleading burden.

Section 1962

Plaintiff's complaint fails to allege one of the elements needed to state a violation of section 1962—that defendant Newman engaged in "racketeering activity." Section 1961(5) defines "pattern of racketeering activity" as at least two acts of "racketeering activity" occurring within ten years of each other. 18 U.S.C. §1961(5) (1976).[11] In turn, section 1961(1)(D) defines "racketeering activity" to include "any offense involving fraud . . . in the sale of securities." 18 U.S.C. § 1961(1)(D) (Supp. III 1979).[12]

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11 (5) "pattern of racketeering activity" requires at least two acts of racketeering activity, one of which occurred after the effective date of this chapter [October 15, 1970] and the last of which occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity.

18 U.S.C. § 1961(5) (1976).

12 (1) "Racketeering activity" means (A) any act or threat involving murder, kidnaping, gambling, arson, robbery, bribery, extortion, or dealing in narcotic or other dangerous drugs, which is chargeable under State law and punishable by imprisonment for more than one year; (B) any act which is indictable under any of the following provisions of title 18, United States Code: Section 201 (relating to bribery), section 224 (relating to sports bribery), sections 471, 472, and 473 (relating to counterfeiting), section 659 (relating to theft from interstate shipment) if the act indictable under section 659 is felonious, section 664 (relating to embezzlement from pension and welfare funds), sections 891-894 (relating to extortionate credit transactions), section 1084 (relating to the transmission of gambling information), section 1341 (relating to mail fraud), section 1343 (relating to wire fraud), section 1503 (relating to obstruction of justice), section 1510 (relating to obstruction of criminal investigations), section 1511 (relating to the obstruction of State or local law enforcement), section 1951 (relating to interference with commerce, robbery, or extortion), section 1952 (relating to racketeering), section 1953 (relating to interstate transportion of wagering paraphernalia), section 1954 (relating to unlawful welfare fund

Plaintiff sought to satisfy both the "pattern" and "racketeering" elements of RICO by alleging that "[d]efendants' actions as set forth herein in this Complaint constitute at least two acts of fraud in connection with the purchase and sale of securities and as such represent a pattern of racketeering activity within the meaning of RICO." J. App. at 11. Thus, the complaint clearly relies on Newman's allegedly "fraudulent" securities transactions with respect to Deseret stock as the predicate acts of "racketeering" that form the "pattern" underpinning plaintiff's RICO claim. Such allegations of fraud would ordinarily satisfy RICO's "racketeering activity" pleading prerequisite.[13]

> payments), section 1955 (relating to the prohibition of illegal gambling businesses), sections 2314 and 2315 (relating to interstate transportation of stolen property), sections 2341-2346 (relating to trafficking in contraband cigarettes), sections 2421-24 (relating to white slave traffic), (C) any act which is indictable under title 29, United States Code, section 186 (dealing with restrictions on payments and loans to labor organizations) or section 501(c) (relating to embezzlement from union funds), or (D) *any offense involving* fraud connected with a case under title 11, *fraud in the sale of securities*, or the felonious manufacture, importation, receiving, concealment, buying, selling, or otherwise dealing in narcotic or other dangerous drugs, punishable under any law of the United States.

18 U.S.C. § 1961(1)(D) (Supp. III 1979) (emphasis added).

[13] Although the district court's opinion voices an extreme reluctance to extend RICO's civil remedies to garden variety securities fraud claims, *see* 553 F.Supp. at 1361, a number of courts have entertained both civil and criminal RICO claims premised on common law fraud and "ordinary" securities fraud violations. For civil cases *see, e.g.*, *USACO Coal Co.* v. *Carbomin Energy, Inc.*, 689 F.2d 94, 95-96 (6th Cir. 1982); *Mauriber* v. *Shearson/American Express, Inc.*, 546 F.Supp. 391, 395-96 (S.D.N.Y. 1982); *Harper* v. *New Japan Securities Int'l*, 545 F.Supp. 1002, 1003 (C.D. Cal. 1982); *Maryville Academy* v. *Loeb Rhoades & Co.*, 530 F.Supp. 1061, 1064-65 (N.D. Ill. 1981); *Engl* v. *Berg*, 511 F.Supp. 1146, 1154 (E.D. Pa. 1981); *Landmark Savings & Loan* v. *Loeb Rhoades, Hornblower & Co.*, 527 F.Supp. 206 (E.D. Mich. 1981); *United States* v. *DePalma*, 461 F.Supp. 778, 785 (S.D.N.Y. 1978); *Farmers Bank* v. *Bell Mortgage Corp.*, 452 F.Supp.

However, in section I of this opinion, we held that plaintiff Moss' pleadings had failed *as a matter of law* to state a claim that Newman had *defrauded* him in violation of section 10(b) and rule 10b-5. In affirming the district court's grant of Newman's 12(b)(6) motion to dismiss, we dismissed plaintiff's claim of "securities fraud" from the complaint. In addition, the district court's dismissal of plaintiff's section 14(e), rule 14(e)-3 and common law fraud claims was never appealed. Therefore, since the complaint contains no *valid* allegation of "fraud,"[14] to underpin the "predicate acts" of "racketeering," it necessarily must fail.

With respect to the sufficiency of the "racketeering" allegations, the district court's decision in *Mauriber* v. *Shearson/American Express, Inc.*, 546 F.Supp. 391 (S.D.N.Y. 1982), is instructive. There the plaintiff alleged that defendant's mismanagement of a discretionary brokerage account violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), and RICO, 18 U.S.C. § 1962(c) (1976). In response to defendant's Rule 12(b)(6) motion the district court found that

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1278, 1279 (D. Del. 1978); for criminal cases *see, e.g., United States* v. *Weisman*, 624 F.2d 1118, 1124 (2d Cir.), *cert. denied*, 449 U.S. 871 (1980); *United States* v. *Pray*, 452 F.Supp. 788, 793 (M.D. Pa. 1978).

[14] Although RICO provides that "fraud in the sale of securities" may constitute "racketeering activity," it supplies neither a definition of "fraud" nor a reference to other federal laws contemplated in drafting this "predicate offense."

The district court did not define "RICO fraud" when it dismissed plaintiff's complaint. Similarly, we need not decide this complex and far-reaching question. Following the district court's rejection of plaintiff's 14(e) and common law fraud claims, we put to rest any lingering existence of "fraud" in the instant complaint by rejecting plaintiff's section 10(b) and rule 10b-5 claims. Therefore, as neither common law fraud nor traditional securities fraud underpins plaintiff's RICO claim, we need not delineate RICO's definition of "fraud in the sale of securities."

plaintiff had failed to state its section 10(b) fraud claim with sufficient particularity to meet the pleading requirements of Fed. R. Civ. P. 9(b). The court further concluded that:

> [T]he RICO claim must fail for reasons not advanced by defendants. In Count II, the complaint alleges a violation of RICO by vaguely referring back to all of the preceding paragraphs that constitute the Section 10(b) violation. As earlier stated, the securities fraud allegations fail in numerous respects to comply with the specificity requirements of Fed. R. Civ. P. 9(b). *Until such time as plaintiff adequately pleads fraud it will not be known whether a RICO violation is properly alleged.* As a result, Count II of the complaint is dismissed with leave to replead within 20 days of the date hereof.

Id. at 397 (emphasis added); *accord Maryville Academy* v. *Loeb Rhoades & Co.*, 530 F.Supp. 1061, 1070 (N.D. Ill. 1981) (Court notes that "filing the lawsuits is not fraud in connection with a securities transaction; *thus* the filings are not within the scope of racketeering activity under the RICO statute."); *see also Van Schaick* v. *Church of Scientology*, 535 F.Supp. 1125, 1138 (D. Mass. 1982).

The instant complaint suffers from a defect more fundamental than that found in *Mauriber*. As plaintiff has failed to state a valid claim that defendant Newman's securities transactions were "fraudulent" violations of section 10(b) or rule 10b-5, we cannot now conclude that such acts represent "racketeering activity" sufficient to support his RICO cause of action. Rather, since our dismissal of the securities fraud claim so undercut the existence of any "racketeering activity" in the com-

plaint,[15] we affirm the district court's dismissal of plaintiff's RICO claim.

[15] In speaking of plaintiff's RICO claim, the district court apparently believed that "[p]laintiff rests his argument that Newman is liable in treble damages for a violation of RICO on *the mere fact that Newman has been convicted of violating some of the statutes listed in Section 1961*." 553 F.Supp. at 1363 (emphasis added). Conceivably, Newman's prior convictions for mail fraud, as well as securities fraud (both enumerated as racketeering activities within 18 U.S.C. § 1961(1)), could provide the proof of the predicate acts of "racketeering" that is presently absent from the complaint.

Although the courts have noted that prior convictions for alleged predicate offenses are not preconditions to bringing a RICO civil suit, *see, e.g., USACO Coal Co.* v. *Carbomin Energy, Inc.*, 689 F.2d 94, 95 n.1 (6th Cir. 1982); *United States* v. *Malatesta*, 583 F.2d 748, 757 (1978), *aff'd on rehearing*, 590 F.2d 1379 (5th Cir.), *cert. denied*, 444 U.S. 846 (1979); *Glusband* v. *Benjamin*, 530 F.Supp. 240, 241 (S.D.N.Y. 1981); *see also State Farm Fire and Casualty Co.* v. *Estate of Caton*, 540 F.Supp. 673, 675 (N.D. Ind. 1982); *Heinold Commodities, Inc.* v. *McCarty*, 513 F.Supp. 311, 313-14 (N.D. Ill. 1979); *Parnes* v. *Heinold Commodities, Inc.*, 487 F.Supp. 645, 647 (N.D. Ill. 1980); *Farmers Bank* v. *Bell Mortgage Corp.*, 452 F.Supp. 1278, 1280 (D. Del. 1978); *but see Kleiner* v. *First National Bank*, 526 F.Supp. 1019, 1022 n.2 (N.D. Ga. 1981) ("It may well be that entitlement to the civil remedy of section 1964 should be conditioned upon a criminal conviction or at least an indictment."), a growing number of courts have recognized that a prior criminal conviction on the alleged predicate offense may exert a collateral estoppel effect on the issue of "racketeering activity" in pleading a "civil RICO" claim. *See Municipality of Anchorage* v. *Hitachi Cable, Ltd.*, 547 F.Supp. 633, 644 (D. Ala. 1982) ("Under traditional theories of collateral estoppel, Hitachi's pleas of guilty to the mail and wire fraud counts estop it from denying that it engaged in a pattern of racketeering activity. . . ."); *Anderson* v. *Janovich*, 543 F.Supp. 1124, 1127-32 (W.D. Wash. 1982); *State Farm Fire and Casualty Co.* v. *Estate of Caton*, 540 F.Supp. at 682-83; *but see United States* v. *Malatesta*, 583 F.2d at 757 ("Because the United States was not a party in the state proceedings, it is not collaterally estopped from proving in the federal prosecutions [RICO] facts that the state was unable to prove."). *See generally*, Tarlow, *RICO: The New Darling of the Prosecutor's Nursery*, 49 Fordham L. Rev. 165, 266-67 (1980).

However, we need not examine the collateral estoppel effect of Newman's criminal conviction in this case. Plaintiff's complaint never mentioned the existence of Newman's prior criminal conviction, let alone presented it as proof of "racketeering activities" sufficient to support the RICO claim.

C. *District Court Dismissal of RICO*

We now turn to the remaining rationales offered by the district court to support its dismissal of plaintiff's RICO claim. The district court dismissed the RICO claim on the grounds that plaintiff had failed to allege several elements essential to pleading such a claim. Most notably, the court found that the complaint failed to allege (1) the existence of an "enterprise" and that this "enterprise" was economically independent from defendants' "pattern of racketeering activity,"[16] and (2) that the "enterprise," or

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16 The district court also required plaintiff to plead a third allegation:

> plaintiff's injury to be cognizable under RICO must be caused by a RICO violation and not simply by the commission of a predicate offense . . . . RICO's civil remedy provision permits a recovery to "any person injured in his business or property *by reason of a violation of Section 1962*," . . . that is, where the distinctive RICO violation contributed to plaintiff's injury, i.e., where the plaintiff suffered directly a racketeering enterprise injury at the hands of those sought to be reached by the Organized Crime Control Act of 1970.

553 F.Supp. at 1361.

In so stating, the district court joined a growing number of courts that have limited standing under 18 U.S.C. § 1964(c) to those "plaintiffs alleging something more, or different, than direct injury resulting from the predicate acts that constitute the racketeering activity. Instead, a plaintiff must allege a commercial or 'racketeering enterprise' injury." *Johnsen* v. *Rogers*, 551 F.Supp. 281, 284-85 (C.D. Cal. 1982) (footnote omitted); *see Cenco, Inc.* v. *Seidman & Seidman*, 686 F.2d 449, 457 (7th Cir.), *cert. denied*, 51 U.S.L.W. 3258 (U.S. Oct. 4, 1982); *North Barrington Development, Inc.* v. *Fanslow*, 547 F.Supp. 207, 211 (N.D. Ill. 1980) ("plaintiff must allege how it was injured competitively by the RICO violation in order to state a cause of action under § 1964(c)."); *Harper* v. *New Japan Securities Int'l*, 545 F.Supp. 1002, 1007 (C.D. Cal. 1982); *Van Schaick* v. *Church of Scientology*, 535 F.Supp. 1125, 1137 (D. Mass. 1982); *Landmark Savings & Loan* v. *Loeb Rhoades, Hornblower & Co.*, 527 F. Supp. 206, 208 (E.D. Mich. 1981); *see also* Comment, *Reading the "Enterprise" Element Back into RICO: Sections 1962 and 1964(c)*, 76 Nw. U.L. Rev. 100, 125-33 (1981). *But see Bennett* v. *Berg*, 685 F.2d 1053, 1059 (8th Cir.), *rehearing en banc denied in part and granted in part* (Sept. 16, 1982); *D'Iorio* v. *Adonizio*, 554 F.Supp. 222, 231 (M.D. Pa. 1982); *Hellenic Lines Ltd.* v. *O'Hearn*, 523 F.Supp. 244, 248 (S.D.N.Y. 1981); *see also*

any of the defendants, had a tie to "organized crime." We do not agree with the district court's assessment that these omissions required dismissal of the complaint.

1. *Civil RICO*

The district court's opinion is replete with expressions of concern about the broad scope of civil RICO. The court began its analysis by noting that "[t]he Racketeer Influenced and Corrupt Organizations Act, part of the Organized Crime Control Act of 1970, was designed in a multifaceted campaign against the pervasive presence of organized crime infiltrated in American business and trade," 553 F.Supp. at 1359, and then cautioned that "[t]he statutory language and recent Supreme Court and Second Circuit precedent, if carefully applied, can be extraordinarily effective in limiting RICO to its intended scope and filtering out many RICO claims that are just efforts to claim treble damages for ordinary violations of criminal or tort laws." *Id.* at 1360. The court continued, "[t]he sweep of the statute does not embrace ordinary violators charged in common law fraud actions or federal securities law violations as the predicate offenses for RICO relief," *id.* at 1361, and finally concluded that "there is nothing in the legislative history to suggest that Congress intended to create a private right of action for

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Blakey & Gettings, *Racketeer Influenced and Corrupt Organizations (RICO); Basic Concepts—Criminal and Civil Remedies*, 53 Temple L.Q. 1009, 1040-43 (1980); Strafer, Massumi & Skolnick, *Civil RICO in the Public Interest: "Everybody's Darling,"* 19 Am. Crim. L. Rev. 655, 689-707 (1982).

The district court subscribed to this interpretation of section 1964(c), but never explained its understanding of a racketeering enterprise injury. We need not decide whether such an interpretation is proper because we find that plaintiff has not satisfied the threshold burden of showing that he suffered *any* injury "*by reason of*" defendants' unlawful conduct.

treble damages for violations of substantive statutes by ordinary business or parties." *Id.* at 1361.

We sympathize with the district court's concerns. However, it is not the "[judiciary's] role to reassess the costs and benefits associated with the creation of a dramatically expansive . . . tool for combating organized crime." *Schact* v. *Brown*, slip op. at 36 (citing *United States* v. *Turkette*, 452 U.S. at 586-87). In this regard we agree with the author of the Note, *Civil RICO: The Temptation and Impropriety of Judicial Restriction*, 95 Harv. L. Rev. 1101, 1120-21 (1982):

> Courts should not be left to impose liability based on their own tacit determination of which defendants are affiliated with organized crime. Nor should they create standing requirements that would preclude liability in many situations in which legislative intent would compel it. Complaints that RICO may effectively federalize common law fraud and erode recent restrictions on claims for securities fraud are better addressed to Congress than to courts.

Although we appreciate the concerns motivating the district court to limit RICO's scope, we believe that the court misinterpreted the elements essential to pleading a RICO cause of action.

2. *Organized Crime*

The district court stated that "application of RICO should be restricted sharply to organized crime and the enterprises on which its talons have fastened. Thus, courts in the Southern District and elsewhere have held that RICO claims for damages could be maintained only if there was a tie to organized crime." 553 F.Supp. at 1361 (citing *Noonan* v. *Granville-Smith*, 537 F.Supp. 23, 29

(S.D.N.Y. 1981); *Barr* v. *WUI/TAS, Inc.*, 66 F.R.D. 109, 112-13 (S.D.N.Y. 1975); and *Waterman Steamship Corp.* v. *Avondale Shipyards, Inc.*, 527 F.Supp. 256, 260 (E.D. La. 1981)); *accord Wagner* v. *Bear, Stearns & Co.*, [current] Fed. Sec. L. Rep. (CCH) ¶ 99,032 (N.D. Ill. 1982); *City of Atlanta* v. *Ashland-Warren, Inc.*, 1982-1 Trade Cas. (CCH) ¶ 64,527 (N.D. Ga. 1982).

It is true that RICO's legislative history states that it was enacted to provide "enhanced sanctions and new remedies to deal with the unlawful activities of those engaged in organized crime." Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 922, *reprinted in* 1970 U.S. Code Cong. & Ad. News 1073; *see United States* v. *Ivic*, 700 F.2d 51, 62 (2d Cir. 1983). The language of the statute, however, does not premise a RICO violation on proof or allegations of any connection with organized crime.[17]

3. *The "Enterprise" Element*

The district court recognized that section 1962(c) requires plaintiffs to plead that an "enterprise" exists and that "there must be some nexus between the pattern of

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17 Similarly, the Act's legislative history supports a rejection of this "organized crime" element. During the House debates on RICO, Congressman Biaggi proposed an amendment that sought to limit the application of RICO to Mafia and La Cosa Nostra organizations. 116 Cong. Rec. 35,343 (1970). The amendment was vigorously attacked on constitutional grounds. Congressman Celler objected that such terms were "imprecise, uncertain, and unclear" and that mere membership in an organization should not be punished. *Id.* at 35,343-44 (1970). Congressman Poff (the bill's sponsor in the House) objected that such an amendment might violate the Supreme Court's rulings that struck down statutes which created status offenses, such as *Scales* v. *United States*, 367 U.S. 203 (1961), and *Robinson* v. *California*, 370 U.S. 660 (1962). 116 Cong. Rec. 35,344 (1970). Congress rejected the amendment. 116 Cong. Rec. 35,346 (1970); *see* Cornell Institute on Organized Crime, Techniques in the Investigation and Prosecution of Organized Crime 59-105 (G.R. Blakey ed. 1980).

racketeering activity and the enterprise." 553 F.Supp. at 1363. We agree. Section 1962(c) states: "It shall be unlawful for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity . . . ." 18 U.S.C. § 1962(c) (1976). "Enterprise" is defined as "any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity." 18 U.S.C. § 1961(4) (1976); *see United States* v. *Turkette*, 452 U.S. 576, 581-82 (1981).

Yet, in addition to requiring plaintiff to plead the existence of this "enterprise," the district court required him to allege facts showing that the "enterprise" had an "independent economic significance from the pattern of racketeering activity." 553 F.Supp. at 1363. The district court concluded that because Morgan Stanley's and Newman's alleged "pattern of activity [was] identical to the enterprise . . . the plaintiff completely fails to make out this element [enterprise] of a RICO claim." *Id.* This conclusion cannot stand in light of our recent decisions in *United States* v. *Mazzei*, 700 F.2d 85 (2d Cir. 1983), *cert. denied*, 51 U.S.L.W. 3841 (U.S. May 23, 1983), and *United States* v. *Bagaric*, 706 F.2d 42 (2d Cir. 1983).

In *United States* v. *Mazzei* we expressly rejected the Eighth Circuit's view that the evidence offered to prove the "enterprise" and "pattern of racketeering" must necessarily be distinct. *Id.* at 89-90; *see Bennett* v. *Berg*, 685 F.2d at 1060; *United States* v. *Anderson*, 626 F.2d 1358, 1372 (8th Cir. 1980) (enterprise "to encompass only an association having an ascertainable structure which exists for the purpose of maintaining operations directed toward an economic goal that has an existence that can be

defined apart from the commission of the predicate acts constituting the 'pattern of racketeering activity.' "), *cert. denied*, 450 U.S. 912 (1981). Instead, we relied on the Supreme Court's decision in *Turkette* that "proof used to establish the 'pattern of racketeering activity' element 'may in particular cases coalesce' with the proof offered to establish the 'enterprise' element of RICO." *United States* v. *Mazzei*, 700 F.2d at 89 (quoting *United States* v. *Turkette*, 452 U.S. at 583); *see United States* v. *Bagaric*, 706 F.2d at 55. In *Mazzei* a group of individuals—bettors and Boston College basketball players—conspired illegally to shave points in Boston College basketball games in order to maximize their gambling proceeds. The "enterprise" consisted of the Boston College conspirators functioning as a "continuing unit, *i.e.*, during the 1978-79 B.C. basketball season" and the "pattern of racketeering activity" consisted of " 'fixing' nine B.C. basketball games." 700 F.2d at 89. We upheld the propriety of Mazzei's RICO conviction even though the proof offered to establish the existence of these two elements had "coalesced." *Id.*; *see United States* v. *Bagaric*, 706 F.2d at 55 ("We have upheld application of RICO to situations where the enterprise was, in effect, no more than the sum of the predicate racketeering acts.").

In this case the "enterprise" allegedly consisted of Courtois' use of his position at Morgan Stanley to obtain confidential information about imminent tender offers; Antoniu's transmission of tender offer information to Newman; and Newman's use of his brokerage abilities to purchase the "target's" stock. The criminal indictment of these individuals reported that their tender offer "enterprise" existed for approximately two years. J. App. at 60-62. As previously mentioned, the "pattern of racketeering activity" consisted of Newman's purchase and

sale of Deseret stock on the basis of the confidential information about the imminent tender offer. We can see no logical or practical basis upon which to distinguish between the enterprise/racketeering relationship of the illegal gamblers in *Mazzei* and the enterprise/racketeering relationship of the securities "schemers" in this case. *See also United States* v. *Errico*, 635 F.2d 152, 156 (2d Cir. 1980) (a network of jockeys and bettors, who joined together for the single illegal purpose of betting on "fixed" horseraces, constituted an "enterprise" for the purposes of RICO), *cert. denied*, 453 U.S. 911 (1981). We find that under the standard articulated in *Mazzei*, the district court erred in its characterization of RICO's "enterprise" and "pattern of racketeering activity" elements.

Summary

We affirm the district court's dismissal of plaintiff's complaint on the grounds that (1) under *Chiarella* and *Dirks* plaintiff's inability to show that any defendant owed him a duty of disclosure precluded a violation of section 10(b) or rule 10b-5; (2) as the individual defendants were not held liable for violating the federal securities laws, Morgan Stanley could not be held derivatively liable under section 20(a) of the 1934 Act; (3) because plaintiff failed to state a claim under section 10(b) of the 1934 Act that defendant Newman committed fraud in the sale of securities, the RICO claim—which premises its "pattern of racketeering activity" on the alleged securities fraud—must likewise fail; and (4) since plaintiff failed to allege that his injury was causally connected to defendant's "unlawful" conduct, his civil RICO claim must be dismissed.

Affirmed.

UNITED STATES DISTRICT COURT,
S.D. NEW YORK
Jan. 10, 1983

No. 82 Civ. 5182(MP)

MICHAEL E. MOSS, *Plaintiff*,

v.

MORGAN STANLEY INC., E. Jacques Courtois, Jr., Adrian Antoniu, and James M. Newman, *Defendants*.

Target corporation shareholder brought action for damages under securities laws and Racketeer Influenced and Corrupt Organizations Act in connection with disclosure of information pertaining to tender offeror's plan to acquire target corporation's stock by employee of investment banker. On motions to dismiss and for summary judgment, the District Court, Milton Pollack, J., held that: (1) none of defendants owed plaintiff duty of disclosure or abstention as required for plaintiff to claim damages under section of Securities Exchange Act prohibiting use of manipulative and deceptive devices in the sale of securities; (2) rule adopted by Securities and Exchange Commission establishing "disclose or abstain from trading" rule under Williams Act should not be given retroactive effect; (3) acts of investment banker's employee for which plaintiff sought to impose liability on investment banker were not of same general nature or similar to authorized conduct so as to impose derivative liability upon investment banker even if acts were unauthorized; (4) no prima facie case of control could be made out under section of Securities Exchange Act providing for liability of controlling persons for acts of controlled parties under certain circumstances; (5) investment banker could not be held liable as aider and abettor of defendants; and (6) allegations of violation of RICO failed to state claims.

Judgment accordingly.

OPINION

MILTON POLLACK, District Judge.

Plaintiff Moss, who seeks to represent the class of all those who sold shares of Deseret Pharmaceutical Company stock on November 30, 1976, brings this suit for damages against Newman, Courtois and Antoniu and Morgan Stanley in the wake of Newman's conviction for securities fraud and mail fraud in connection with a tender offer made for Deseret stock. Moss asserts claims against Newman, Courtois and Antoniu based on Sections 10(b) and 14(e) of the Securities Exchange Act of 1934 and the Rules promulgated thereunder, Rule 10b-5 and Rule 14e-3. In addition, Moss claims that Morgan Stanley is derivatively liable for these Securities Act violations. Moss also asserts pendent state law claims of fraud and claims that Morgan Stanley is liable under the doctrine of respondeat superior. Finally, Moss asserts that all of the defendants, including Morgan Stanley have violated the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961, et seq., and that they are therefore liable for treble damages.

Defendant Newman has moved to dismiss the complaint for failure to state a claim on which relief can be granted pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, and Morgan Stanley has moved to dismiss the complaint under Rule 12(b)(6) and for summary judgment under Rule 56(b) and for attorneys' fees and costs pursuant to Rule 11. For the reasons appearing hereafter, the motions to dismiss the amended complaint will be granted.

Summary Of Events

In December 1976, Warner Lambert Company made a cash tender offer for Deseret Pharmaceuticals Company. On or about November 23, 1976, Warner engaged the services of Morgan Stanley, in its capacity as as investment banker, to advise and assist Warner in its effort to acquire control of Deseret. Morgan Stanley was to investigate Deseret, evaluate its stock and recommend a price for Warner to offer Deseret

shareholders in a tender offer. The defendant, E. Jacques Courtois, Jr., was employed by Morgan Stanley in its Merger and Acquisition Department. In that capacity, Courtois obtained knowledge of Warner's plan.

On or about November 30, 1976, Courtois disclosed to defendant Adrian Antoniu the information pertaining to Warner's plan to acquire Deseret stock. Antoniu was at the time an employee of Kuhn Loeb & Co., another broker-dealer and investment banker. Antoniu then disclosed the non-public information about the planned Warner offering to defendant James M. Newman, a stockbroker. The latter advised certain of his customers to buy Deseret stock in anticipation of Warner's tender offer, and purchased Deseret stock for his own account and others at prices substantially below the price which Warner offered to Deseret stockholders shortly thereafter.

As a result of these activities, Newman was tried and convicted on 15 counts of fraud. Antoniu pleaded guilty. Courtois was indicted but has not yet been tried as he is presently believed to be living in South America.

Section 10(b) Claim.

A plaintiff claiming damages under Section 10(b) must establish the existence of a special relationship by the defendant with an insider or the plaintiff. Absent this, nondisclosure of nonpublic market information is not actionable. "The essential purpose of Rule 10b-5 . . . is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974), quoting *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1974). Thus, as stated in *Frigitemp Corp.* v. *Financial Dynamics Fund*, 524 F.2d 275, 282 (2d Cir. 1975), "the party charged with failing to disclose market information must be under a duty to disclose it to the plaintiff."

In this case, none of the defendants owed plaintiff a duty of disclosure or abstention. None of the defendants had any tie to

the issuer, Deseret, in whose stock they traded. As Morgan Stanley was not employed by Deseret but by Warner, neither Morgan Stanley nor its employees were insiders of Deseret. Thus, Newman, even if he is viewed as standing in the shoes of the Morgan Stanley employee, Courtois, when he traded, purchased stock on the basis of information that was obtained from a source outside the issuer. While the information that led to the purchase was nonpublic, it was outside not inside information.

The argument that defendants did not owe the requisite duty to the plaintiff is based on *Chiarella* v. *United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed. 348 (1980), where the Supreme Court held that an individual who was not an insider of the issuer in whose stock he traded could not be found to have violated Section 10(b) based on a theory of the breach of a duty to the shareholders of the issuer. In *Chiarella, supra*, the Court reversed the conviction under Section 10(b) of a printer who had traded in stock on the basis of non-public information that he had obtained in the course of his employment. Like the defendants in the present action, Chiarella was an outsider of the corporations in whose stock he traded. The Court stated:

> [T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their confidence.

Id. at 232, 100 S.Ct. at 1117.

The Supreme Court argument compels a finding that Newman, Courtois and Antoniu cannot be liable to plaintiff for a violation of Section 10(b). As outsiders of Deseret, they did not owe the Deseret shareholders any duty of disclosure before trading. As the Ninth Circuit has recently noted:

> A purchaser of stock who has no fiduciary relation to the prospective seller of the stock and who owns less than 5%

> . . . has no duty to disclose circumstances that will insure that the purchaser pays the highest possible price.

Polinsky v. *MCA, Inc.*, 680 F.2d 1286, 1290 (9th Cir. 1982). As no duty to disclose or abstain was owed to the Deseret stockholders, they have no standing to sue for damages under Section 10(b) as the essential element of a breach of a duty owed to them is absent.

Recognizing that in order to set out a claim for damages under Section 10(b) one must show that the defendants have breached a duty owed to the plaintiff, Moss attempts to find a source that could create a duty owed to him by defendants. One of these efforts to create a duty to the stockholders of Deseret focuses on the duty that Courtois owed to Morgan Stanley. Plaintiff argues that Courtois owed a fiduciary duty to Morgan Stanley and to Morgan Stanley's client Warner. He claims that this duty to Morgan Stanley and its client Warner gave rise to a separate duty to disclose or abstain that was owed to the shareholders of Deseret. This argument fails.

It is true that a criminal violation of Section 10(b) can be based upon the breach of a duty owed to a party other than the party to the transaction. While the Supreme Court has not specifically addressed the question, the Second Circuit has held that *criminal* violation of Section 10(b) can be based on the breach of a duty owed to the acquiring corporation or other party even though no duty is owed to the issuer. *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981). In *Newman, supra*, the Court reversed the dismissal of the Section 10(b) count against the defendant Newman of this present action. It held that Courtois did owe a duty to Morgan Stanley and its client Warner and that Newman, as Courtois' tippee, was subject to this same duty. Thus, as there was a breach of a duty, Section 10(b) liability was possible. It is essential to note, however, that this case did not find any duty owed to the issuer, Deseret, or to its stockholders. As *Newman, supra*, was a criminal prosecution, this question of privity of the stockholders of Deseret was not before the Court, and it was not addressed.

Thus, even though there may have been a fiduciary duty to Morgan Stanley and Warner in this case, there is no support for the argument that this duty transformed itself into a duty owed to the stockholders of Deseret, as is necessary for a finding that Moss has a claim for damages under Section 10(b). A holding that the duty owed to Morgan Stanley and Warner gives rise to a duty to the stockholders of Deseret would be wholly inconsistent with the teaching of the Supreme Court in *Chiarella, supra*, that a duty to disclose under Section 10(b) arises out of a relationship of trust and confidence. *Id.* 445 U.S. at 230, 100 S.Ct. at 1115. This relationship must be one between the parties themselves. *Id.* at 231, n. 14, 100 S.Ct. at 1116 n. 14. Thus, plaintiff cannot hope to piggyback upon the duty owed by defendants to Morgan Stanley and Warner. There is no "duty in the air" to which any plaintiff can attach his claim.

Further support for this analysis comes from the following passage in *Chiarella, supra:*

> We know of no rule of law . . . that a purchaser of stock, who was not an "insider" and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale. *Id.* at 232, n. 14, 100 S.Ct. at 1116 n. 14. The duty to disclose arises from a relationship between the parties. Here, the defendants were not insiders of Deseret, had no fiduciary relation with Deseret's stockholders, and thus owed them no duty of disclosure. Consequently, there is no Section 10(b) damage liability of defendants to them.

Plaintiff asserts that the Southern District case of *O'Connor & Associates* v. *Dean Witter Reynolds, Inc.*, 529 F.Supp. 1179 (S.D.N.Y. 1981), suggests a different conclusion. Plaintiff argues that *O'Connor, supra,* stands for theory that the fiduciary duty that traders owe to their corporation creates a separate duty to the investing public to disclose or abstain. There are several problems with relying on *O'Connor, supra.*

O'Connor, supra, can be distinguished on its facts. The plaintiffs there claimed that the information traded upon with-

out disclosure had come from the issuer, the other party to the merger, or both. While the Court did not specifically state that its conclusion would differ if the information had not come from insiders, it did base much of its analysis on the duty of insiders. Thus, the Court did distinguish *Chiarella, supra,* by noting that in *O'Connor, supra,* the alleged sources of material information were insiders. This supports a reading of *O'Connor, supra,* to apply only to the situation of information leaked from the issuer. Any other reading of the case would flatly contradict the language in *Chiarella, supra,* that states that a duty to disclose arises from a relation between the parties. *Id.* 445 U.S. at 231, n. 14, 100 S.Ct. at 1116 n. 14.

Plaintiff points to other alleged sources of a duty to disclose in addition to the duty to Morgan Stanley and Warner. Plaintiff claims that the negotiations between Warner and Deseret established a duty on the part of Morgan Stanley to disclose or abstain before trading and that this duty arose out of a duty that Warner owed to Deseret to bargain in good faith. If during the course of the bargaining leading up to the offer for the Deseret stock, Warner Lambert received confidential information from Deseret with the understanding that this information would be used by Warner only for legitimate corporate purposes, this could have imposed a duty on Warner not to abuse the information that it received. Morgan Stanley and its employees would then have been brought into a trust relation with Warner and thus could have become subject to the same duty owed to Deseret. If valid, this argument might allow plaintiff to prove that Courtois owed the sellers a duty arising out of the trust relationship of the bargaining process.

The most recent Second Circuit case on the question of the duty owed by an investment bank to a potential target when it represents the acquring corporation is *Walton* v. *Morgan Stanley*, 623 F.2d 796 (2d Cir. 1980). Morgan Stanley first represented Kennecott Copper Corporation while that corporation was considering the acquisition of Olinkraft. In the course of these negotiations, Olinkraft gave Morgan Stanley confidential inside information on the condition that Morgan

Stanley use the information only in connection with its work on the Kennecott bid and that it then return the information to Olinkraft. The Kennecott bid did not materialize, but other companies did make bids for Olinkraft. Morgan Stanley's Arbitrage Department then purchased stock in Olinkraft. Morgan Stanley's Merger and Acquisitions Department, aware of the purchases by the Arbitrage Department, then used the confidential information to convince Johns-Manville to make a bid for Olinkraft.

Plaintiffs in *Walton, supra,* sued derivatively, claiming that Morgan Stanley had breached a fiduciary duty that it owed to Olinkraft. The Second Circuit rejected this argument. The Court stated:

> Put bluntly, although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan Stanley owed no duty to observe that confidence.

Id. at 799. The Court noted that facts had been presented to it to indicate that anything but an arm's length bargaining relationship had existed between Olinkraft and Morgan Stanley and Kennecott Copper.

Walton was based upon Delaware law as Olinkraft was a Delaware corporation. It is not possible to determine from the complaint and papers whether Deseret is a Delaware corporation or not. Note, however, that the Second Circuit's construction of New York fiduciary law results in a similar result. In *Frigitemp Corp.* v. *Financial Dynamics Fund,* 524 F.2d 275 (2d Cir. 1975), the Court found that no fiducuary duty to a corporation had been created under New York law on the part of investment companies that had negotiated with the corporation regarding the purchase of corporate debt. As the negotiations had been at arm's length, no fiducuary duty had been created. The inside information that the investment companies had acquired could be traded upon.

Thus, unless plaintiffs can set forth facts that turn the negotiations from arm's length bargaining into a fiduciary rela-

tionship, they cannot claim that Morgan Stanley owed them a fiduciary duty. The plaintiffs assert that the following facts show that there was a fiduciary relationship:

1. The parties to the tender offer had negotiated for some time prior to the announcement.
2. Morgan Stanley had obtained some of its information directly from Deseret.
3. Deseret requested that trading in its stock be suspended upon the offer, thus showing that it wished the offer to proceed in an orderly manner.

These facts do not indicate any more of a duty on the part of Morgan Stanley than was present in *Walton, supra*, where there had been negotiations and a specific request by the target not to reveal the information. As the Second Circuit found that Morgan Stanley owed the target no duty in *Walton, supra*, this Court finds that no duty existed here.

Plaintiff also argues that Newman, as a registered broker-dealer breached an additional duty, that of market professional to the market. Plaintiff relies on *Dirks* v. *S.E.C.*, 681 F.2d 824 (D.C. Cir. 1982), *cert. granted*, ___ U.S. ___, 103 S.Ct. 371, 74 L.Ed.2d 506 (1982), for this theory. While it is true that *Dirks, supra*, did note that brokers-dealers were subject to duties not imposed on the general public, this case cannot support an argument that the breach of a duty to the market creates a private cause of action. First, *Dirks, supra*, was an action to censure a broker-dealer. There was no discussion of what created a duty to disclose or abstain so as to give rise to Section 10(b) damage liability. Second, the information that Dirks failed to make publicly available before he passed it on to clients was inside information received from sources at the issuer.

Plaintiff has failed to state a claim on which relief may be granted under Section 10(b) of the Securities Exchange Act. In order to obtain damages for a violation of this Section, a plaintiff must show that a duty to disclose or abstain was owed by the defendants and that it has been breached. Plaintiff has not

shown any duty owed to him by the defendants. They were outsiders of the corporation of which plaintiff was a stockholder. There was no fiduciary relationship of any nature between the parties. The only duty owed by defendants was that to Morgan Stanley and to Warner. Any effort to create a duty to plaintiff out of this duty contradicts the Supreme Court requirement that the duty giving rise to a violation of Section 10(b) arises out of a relationship between the parties.

Section 14(e) Liability.

Plaintiff also claims that Newman violated Section 14(e) of the Securities Exchange Act. Newman has moved to dismiss that complaint arguing that Rule 14e-3, which was adopted by the Securities and Exchange Commission on September 12, 1980, was the first effort by the Securities and Exchange Commission to make his actions illegal. As the actions involved in this litigation took place before the adoption of the Rule, Newman claims that his conduct did not violate Section 14(e).

Rule 14e-3 should not be given retroactive effect. The SEC Release accompanying Rule 14e-3 suggests that the SEC viewed the rule as altering the interpretation of Section 14(e) and as prospective in effect. *Tender Offer Fraud Rule*, 1934 Act Release No. 17120, Fed.Sec.L.Rep. [CCH] ¶ 82,646. This Release stated that "Rule 14e-3 *establishes* a 'disclose or abstain from trading' rule under the Williams Act," *id.* at 83,453 (emphasis added). Also, the Release stated that the Rule would be effective thirty days after the publication of the Release in the Federal Register. *Id.*

This language supports the finding that Rule 14e-3 was altering the interpretation of Section 14e-3 was altering the interpretation of Sectin 14(e) and creating new liability. Before the adoption of the Rule, Section 14(e) could not cover the acts of defendants. The District Court that dismissed the indictment of Newman, *United States* v. *Courtois*, Fed.Sec.L.Rep. [CCH] ¶ 98.024 at 91,-292 (S.D.N.Y. 1981) *rev'd on other grounds sub. nom. United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981), noted that before Rule 14e-3 was adopted in 1980,

the Williams Act had no "cure" for the problem of individuals trading on the basis of non-public information that a tender offer would be made.

Thus, as Rule 14e-3 cannot be given retroactive effect and as the Williams Act as interpreted before the Rule's adoption did not cover Newman's, Courtois' or Antoniu's acts, the Section 14(e) claim must be dismissed.

Derivative Liability Of Morgan Stanley.

Plaintiff asserts that Morgan Stanley is liable derivatively for the Securities Acts violations of the individual defendants on theories of respondeat superior, aiding and abetting, and control person liability under Section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a). As the claims against the individuals have been dismissed, Morgan Stanley cannot be derivatively liable. Yet, it should be noted that the arguments that Morgan Stanley could be liable for any Section 10 or 14 violation are completely devoid of merit. Even if the underlying claims did state a claim on which relief might be granted against the individual defendants, they would fall as against Morgan Stanley.

Respondeat Superior.

Plaintiff asserts that the common law doctrine of respondeat superior makes Morgan Stanley derivatively liable for the acts of its employee, Courtois. Plaintiff claims that the acts of an employee that are of the same general nature as, or sufficiently similar to, the authorized conduct will be adequate to impose derivative liability even if the acts are unauthorized. While it is correct that unauthorized acts can fall within the scope of employment and thus subject the employer to liability, the acts of Courtois cannot be so categorized.

As Judge Lasker noted in *O'Connor, supra* at 1194:

> [I]nsider trading and tipping cannot ordinarily [be] said to be within the course of employment. An employee who trades on the basis of material inside information or who

> tips cannot be said to act as an employee in the transaction. . . . [A]n employee who trades on the basis of inside information or who tips such information must normally be viewed as on a frolic of his own.

This analysis applies to Courtois. Like the employee in *O'Connor, supra,* the only link between the tip and the employment duties was that the latter constituted the source of the tip. The illegal trading did not take place on or use the facilities of the employer. No one dealing with the employee could have thought that the acts were authorized by the employer. The mere fact that the business of Morgan Stanley relates to securities generally is not sufficient to convert the acts of Courtois into acts within the scope of employment or acts similar in nature to authorized conduct. It is especially worthy of note that Courtois was employed in the Mergers and Acquisitions Department of Morgan Stanley. His usual responsibilities related to the analysis of potential targets and the structuring of deals, not to the purchase and sale of securities for his own or for anyone else's account. Thus, the acts for which the plaintiff seeks to impose liability on Morgan Stanley were not of the same general nature or at all similar to authorized conduct.

The cases that plaintiff cites do not alter this conclusion. All of those cases involved acts that the employee undertook in his official capacity or that were the same type of activity usually undertaken. For example, in *Lewis* v. *Walston & Co.*, 487 F.2d 617 (5th Cir. 1973), a broker's acts were attributed to the employer as the broker had been dealing with the customers of the employer as its representative, thereby performing acts "commonly done" by brokers. *Id.* at 623.

Finally, plaintiff asserts that the fact that the illegal act of Courtois was foreseeable should make Morgan Stanley liable. Plaintiff relies on *Bushey* v. *United States*, 398 F.2d 167 (2d Cir.1968), for this test. In *Bushey, supra,* the employer, the United States, was held liable for the actions of a drunken seaman who destroyed a drydock as it was foreseeable that such damage would occur. The Second Circuit, however, was

explicit in limiting its holding to situations in which there was some relation between the act of the employee and the activities of the enterprise. *Id.* at 172. Here, Courtois' actions had no relation to Morgan Stanley, as demonstrated above. Thus, under the *Bushey, supra*, test, Morgan Stanley is not derivatively liable for the acts of Courtois.

Section 20(a) Liability.

Section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), provides that controlling persons can be liable for the acts of controlled parties under certain circumstances. This Section states:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

There is some uncertainty as to the construction of this Section in the Second Circuit. In *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir.1973) (*en banc*), the Second Circuit stated that before liability could be extended to a controlling person under Section 20(a), there must be a showing of "culpable participation" by the party to be held liable. This test was followed in *Gordon* v. *Burr*, 506 F.2d 1080, 1085-86 (2d Cir.1974). If it were clear that the Second Circuit is still following the test set forth in *Lanza, supra*, it would be proper to dismiss the claims on this ground against Morgan Stanley. There is no allegation of any act by Morgan Stanley that even approaches culpable participation, or even participation of any kind at all. Yet, the Second Circuit in *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011, 101 S. Ct. 566, 66 L.Ed.2d 469 (1980), suggested that under certain circumstances inadequate supervision of em-

ployees may result in Section 20(a) liability. Thus, the Court stated that:

> While the precise standard of supervision required of broker-dealers to make good the good faith defense of Section 20(a) is uncertain, where, as in the present case, the erring salesman completes the transactions through the employing brokerage house and the brokerage house receives a commission on the transactions, the burden of proving good faith is shifted to the brokerage house . . . and requires it to show at least that it has not been negligent in supervision . . . and that it has maintained and enforced a reasonable and proper system of supervision and internal control over sales personnel.

Id. at 716.

All that *Marbury Management, supra*, does to the Section 20(a) test is allow plaintiff to make out a prima facie case of control by a showing that the employee acted in the scope of his employment. Thus, in *Savino* v. *E.F. Hutton*, 507 F.Supp. 1225 (S.D.N.Y. 1981), the Court stated that a prima facie showing of control could be made out by a showing that the employer had the means of control of the employee or that there was some control by status. As Courtois was operating outside of the scope of his employment, there is no relationship between the parties to give Morgan Stanley control by status of Courtois with respect to the acts in question. Thus, no prima facie case of control can be made out under Section 20(a).

Aiding and Abetting Liability.

There is also no liability on the part of Morgan Stanley as a result of plaintiff's argument that Morgan Stanley is liable as an aider and abettor of the defendants in this action. The Second Circuit test for aiding and abetting liability has recently been set forth by the Second Circuit in *IIT, an International Investment Trust* v. *Cornfeld*, 619 F.2d 909 (2d Cir.1980). The following must be shown before a defendant can be found to have aided and abetted:

1. The existence of a securities law violation by the primary party.

2. Knowledge of this violation by the aider and abettor.
3. Substantial assistance by the aider and abettor in the achievement of the primary violation.

The requirement of knowledge was further developed as follows:

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter.

Id. at 922. The requirement of substantial assistance has been defined to cover inaction by the defendant in certain limited circumstances. Liability will attach when there is clear evidence of some degree of scienter and a "conscious and specific motivation for not acting" or when there is a conscious or reckless violation of an independent duty to act. *Id.* at 927.

Neither the second nor the third element of the aiding and abetting test is satisfied in this case. As Morgan Stanley had no duty of disclosure to anyone, the knowledge requirement can be met only if there is some conscious intent on the part of Morgan Stanley. No such allegation is made. All that plaintiff asserts is that Morgan Stanley may have been reckless. In addition to their failure to state any fact that can support a finding of recklessness as a matter of law, this argument fails as there can be no satisfaction of the second element of the complaint without a higher degree of scienter than recklessness.

There is also no allegation that can support a finding of substantial assistance. Plaintiff makes no claim that Morgan Stanley had any motivation at all for not acting. As matter of law there was no violation of any independent duty owing to plaintiff to act.

Thus, the attempt to find Morgan Stanley derivatively liable as an aider or abettor fails completely.

RICO Claims.

A. *Morgan Stanley.*

Plaintiff's Count II in the amended complaint charges Morgan Stanley, Inc. with culpability under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1964(c).

The allegations of the amended complaint for this bold charge are the following:

Morgan Stanley rendered advice and assistance to Warner Lambert Company for a tender offer by it for Deseret stock (¶ 9). Morgan Stanley permitted an employee, one Courtois, to gain knowledge of and obtain access to confidential and privileged information pertaining to Warner's planned offer for Deseret stock (¶ 16). Courtois conspired with Antoniu and Newman to utilize to their personal advantage such privileged and confidential information and intentionally and knowingly defrauded plaintiff and class members who sold their Deseret stock at prices below the tender offer price subsequently announced (¶ 22). Morgan Stanley aided and abetted Courtois, Antoniu and Newman in this conspiracy; they failed adequately to supervise Courtois and recklessly and negligently failed to take steps to safeguard the confidential information and are liable therefore as a person in control of Courtois and under common law principles of respondeat superior (¶ 23). Morgan Stanley's actions represent a pattern of [criminal] racketeering activity within the meaning of the Racketeer Influenced and Corrupt Organizations Act (¶ 27).

Plaintiff's brief opposing dismissal of the RICO count notes that Morgan Stanley has reacted with dismay and outrage to the charge associating it with criminal racketeering proscribed by the Racketeering Influenced and Corrupt Organizations Act.

Unless a plaintiff can point to a factual basis for a charge that a defendant is a member of a structured criminal organization with the requisite history of criminal racketeering acts or meets each of the elements requisite to establishing a RICO

charge, civil litigation falls to the ground; indeed, such a charge infects the fundamental fairness of civil litigation.

The Racketeer Influenced and Corrupt Organizations Act, part of the Organized Crime Control Act of 1970, was designed in a multifaceted campaign against the pervasive presence of organized crime infiltrated in American business and trade. The preamble of the statute states its purpose: "To seek the eradication of organized crime in the United States . . . ." The Congress found that there was a drain by organized crime of billions of dollars from America's economy by illegal use of force, fraud and corruption; by syndicated gambling, loan-sharking, theft and fencing of property; by importation and distribution of narcotic and controlled drugs; by infiltration and corruption of legitimate business and labor unions. Pub.L. No. 91-452, 84 Stat. 922-23 (1970).

Congress did not define "organized crime." However, by its very nature, "organized crime" is not susceptible to a clear, concise definition. While organized crime brings to mind loan-sharking, drug dealing, and violent intimidation, it is neither these activities nor the individual or ethnic identity of the participants that separates organized crime from unspecified criminal activity. Entities engaging in organized crime are characterized by the existence of a well defined hierarchy and infrastructure. Organized criminal enterprises also employ numerous individuals whose jobs are to ensure that criminal activity can be carried out without interference from government agents or other competitors of the organization. This preclusion of interference is often accomplished by threat, bribe, or by actual physical violence. Additionally, organized criminal enterprises rely on internal, covert and often violent disciplinary measures for employees who act outside the scope of their authority.

The courts must facilitate the proper application of statutory causes of action and must guarantee that they are not abused and applied to contexts outside those intended by Congress. This is especially true in the civil context where the additional

check and balancing factor of prosecutorial discretion is absent.

Courts have recognized that RICO claims could be proved only if there was a tie to organized crime. These holdings have been criticized because Congress did not explicitly require that racketeering activity be tied to organized crime. Indeed, Congress rejected an amendment to RICO designed to explicitly define organized crime because a "bright line" legislative definition might unconstitutionally create a status offense and because it would be easy for organized criminals to alter their conduct so that they would fall outside of the reach of the statute.

Legislative failure to establish a "bright line" does not imply that Congress intended that Courts repudiate their proper function of legislative interpretation and application. The Courts are routinely called on to apply general criteria on a case by case basis. This is especially true where the underlying subject matter is not well suited to simple definition. Thus, in obscenity and pornography cases, for example, Courts have limited the reach of anti-obscenity laws in light of Constitutional interests by employing general criteria on a case by case basis.[1] Similar judicial action is appropriate in civil RICO cases.

The statutory language and recent Supreme Court and Second Circuit precedent, if carefully applied, can be extraordinarily effective in limiting RICO to its intended scope and filtering out many RICO claims that are just efforts to claim treble damages for ordinary violations of criminal or tort laws. For example, the requirement that the plaintiff show that the injury for which relief is sought resulted from a violation of Section 1962, and not simply from a violation of Section 1961, by the commission of the enumerated acts, eliminates

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[1] *Cf. Jacobellis* v. *Ohio*, 378 U.S. 184, 197, 84 S.Ct. 1676, 1683, 12 L.Ed.2d 793 (1964) (Stewart, J., concurring) ("I know it when I see it.").

from the scope of RICO the cases in which plaintiff seeks to use RICO to claim damages due to an inability to meet the requirements for relief stemming from predicate felonies.

In addition, the requirement of *United States* v. *Turkette*, 452 U.S. 576, 583, 101 S.Ct. 2524, 2528, 69 L.Ed.2d 246 (1981), that the plaintiff must establish that the enterprise is an entity separate and apart from the pattern of racketeering activity makes clear that a violation of RICO is not set forth simply by alleging that the enumerated felonies of Section 1961 have been committed. If the enterprise that the plaintiff is relying upon is the criminal partnership of the defendants, the plaintiff must establish that there is something more to this partnership than the commission of the underlying felonies. For example, a developed infrastructure for the criminal partnership, used to help carry out its goals and enforce its aims, would suffice to give the group an adequate separate identity to meet the requirement of *Turkette, supra*. However, if all that the criminal partnership consists of is the commission of the requisite felonies, no violation of Section 1962 can be shown. Proof that the criminal partnership was an "on-going organization, formal or informal," with its associates functioning "as a continuing unit," *Turkette* at 583, 101 S.Ct. at 2528, will suffice to meet the enterprise requirement.

Criminal prosecution and civil remedies were authorized by RICO. The civil remedies provided in Section 1964 granted a private right of action to litigants injured by a violation of RICO's criminal provision, Section 1962, in addition to the injunctive remedies made available to the Attorney General to stamp out infiltration of legitimate business by divestiture and otherwise.

Section 1964(c) provides that:

> [A]ny person injured in his business or property by reason of a violation of Section 1962 of this chapter may sue . . . and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

The proscribed activities under RICO are described in Section 1962 and enumerated in Section 1961. These are aimed at structured criminal organizations who fund, acquire or maintain enterprises engaged in or affecting interstate or foreign commerce with the proceeds of illegal activities by "(a)" investing income derived from a "pattern of racketeering" in an enterprise or "(b)" acquiring or maintaining an enterprise through "a pattern of racketeering," or "(c)" being employed by or associated with an "enterprise" to conduct or participate "in the conduct of such enterprise's affairs through a pattern of racketeering," or "(d)" to conspire to violate any of the foregoing. (Section 1962).

The statutory definition of a "pattern" of racketeering activity [Section 1961(5)] is "at least two acts of racketeering activity within ten years." "Racketeering activity" is any act of felony of the state or federal law listed in Section 1961(1).

The use of the mails or the sale of securities are named as two of the methods by which the enumerated Section 1961 activities prohibited in Section 1962 may fall under the ban. The cardinal question at the threshold is whether there has been a commission of one of the enumerated prohibited activites—one of the racketeering crimes in the course of organized crime defined by the RICO statute—which has caused injury to the plaintiff.

RICO was thus established as a civil weapon against those engaged in organized crime who have gained an unfair competitive or financial advantage through criminal means associated with racketeering. The statutory offenses created by RICO were aimed at the evils of criminal racketeering by organized crime that had spread through the economy. *United States* v. *Turkette*, 452 U.S. 576, 589, 101 S.Ct. 2524, 2531, 69 L.Ed.2d 246 (1981). The sweep of the statute does not embrace ordinary violators charged in common law fraud actions or federal securities law violations as the predicate offenses for RICO relief, albeit the use thereof to accomplish one of the enumerated felonies in the statute may be an element of and

lead to RICO liability if organized criminals engage in the prohibited activity.

The supporting civil remedies of the statute were designed against organized criminals and terrorists as an additional weapon in the crime fighters' arsenal.

In other words, plaintiff's injury to be cognizable under RICO must be caused by a RICO violation and not simply by the commission of a predicate offense, such as mail fraud or federal securities fraud. RICO's civil remedy provision permits a recovery to "any person injured in his business or property *by reason of a violation of Section 1962,*" 18 U.S.C. Section 1964(c) (emphasis supplied), that is, where the distinctive RICO violation contributed to plaintiff's injury, i.e., where the plaintiff suffered directly a racketeering enterprise injury at the hands of those sought to be reached by the Organized Crime Control Act of 1970. *See* 116 Cong.Rec. 602, et seq.; 607, et seq.; 819, et seq.; 35201, et seq. (1970). The purpose was to provide "enhanced sanctions and new remedies to deal with the unlawful activities of those engaged in organized crime." Congressional Statement of Findings and Purposes, Pub.L. No. 91-452, § 1, 84 Stat. 922, 923.

It has appropriately been said:

> The civil remedies provisions of RICO were not designed to convert every fraud or misinterpretation action involving corporations who use the mails or telephones to conduct their businesses in interstate commerce into treble damage RICO actions.

Waterman S.S. Corp. v. *Avondale Shipyards, Inc.*, 527 F.Supp. 256, 260 (E.D.La. 1981). *See also, Noonan* v. *Granville-Smith*, 537 F.Supp. 23 (S.D.N.Y. 1981).

In civil litigation there is every reason why the application of RICO should be restricted sharply to organized crime and the enterprises on which its talons have fastened. Thus, courts in the Southern District and elsewhere have held that RICO claims for damages could be maintained only if there was a tie to organized crime. *Noonan* v. *Granville-Smith*, 537 F.Supp.

23, 29 (S.D.N.Y.1981), and *Barr* v. *WUI/TAS, Inc.*, 66 F.R.D. 109 (S.D.N.Y.1975). *See also, Adair* v. *Hunt International Resources Corp.*, 526 F.Supp. 736 (N.D.Ill.1981); *Waterman S.S. Corp.* v. *Avondale Shipyards*, 527 F.Supp. 256 (E.D.La.1981).

Moreover, there is nothing in the legislative history to suggest that Congress intended to create a private right of action for treble damages for violations of substantive statutes by ordinary business or parties. For example, it was clearly established at the time that RICO was enacted that there was no private right of action for violations of the mail fraud statute. It is implausible that Congress could have meant to alter this accepted rule to the extent of creating a right of action for treble damages without a single mention of such a revolutionary consequence anywhere in the legislative history.

Plaintiff, on this motion for summary judgment, fails completely to satisfy the requirement that there be an underlying pattern of racketeering activity or even a single act of racketeering by Morgan Stanley. For these reasons alone, the RICO claim fails. Morgan Stanley is not principally charged with any substantive act that could constitute even a single element of racketeering. In order to connect Morgan Stanley with a RICO claim, the plaintiff would have to establish facts which show derivative *criminal* liability as Section 1961 only defines acts to be racketeering if they are one of the enumerated felonies punishable under the laws of the United States.

Note that even if the standard of proof is lower in a civil proceeding under RICO than in a criminal one, this does not relate to the elements of the crime but only to the burden that the plaintiff must bear in showing the elements. *Cf. United States* v. *Cappetto*, 502 F.2d 1351, 1357 (7th Cir. 1974), *cert. denied*, 420 U.S. 925, 95 S.Ct. 1121, 43 L.Ed.2d 395 (1975).

There is no claim herein that Morgan Stanley used its employees or anyone else to violate the Securities Exchange Act. None of the employees complained of made any investment in Morgan Stanely. To the contrary, Morgan Stanley was harmed

by Courtois' and the other defendants' actions as its reputation as a safe repository for clients' secrets was diminished. In addition, in order to carry out his acts, Courtois had to circumvent Morgan Stanley's confidentiality controls and had to trade secretly on an outside account. There is no possible argument that Morgan Stanley is criminally liable for the acts of anyone by reason of Section 20(b) of the Securities Exchange Act, 15 U.S.C. Section 78t(b). That section has been construed as requiring a showing that the controlling person [Morgan Stanley] knowingly used the controlled person to commit the illegal act. *Securities Exchange Commission* v. *Coffey*, 493 F.2d 1304, 1318 (6th Cir.1974), *cert. denied*, 420 U.S. 908, 95 S.Ct. 826, 42 L.Ed.2d 837 (1975). Nor, what plaintiff apparently would argue, is Morgan Stanley derivatively criminally liable under a theory of aiding and abetting. While plaintff alleged in paragraph 23 of his complaint that Morgan Stanley aided and abetted Courtois, Antoniu and Newman in their criminal conspiracy, he has not alleged or shown any fact that can constitute criminal aiding and abetting. It is well-established that in order to find a defendant guilty of aiding and abetting, the defendant must "in some sort associate himself with the venture . . . participating in it as something he wished to bring about [and] seeks by his action to make it succeed." *United States* v. *Clemente*, 640 F.2d 1069, 1079 (2d Cir.) *cert. denied*, 454 U.S. 820, 102 S.Ct. 102, 70 L.Ed.2d 91 (1981), citing *United States* v. *Peoni*, 100 F.2d 401, 402 (2d Cir.1938). In addition, an aider and abettor must have some interest in the criminal venture. Thus, "the mere presence of a defendant where a crime is being committed, even coupled with knowledge by the defendant that a crime is being committed, or the mere negative acquiescence by a defendant in the criminal conduct of others, even with guilty knowledge, is not sufficient to establish aiding and abetting." *United States* v. *Stanchich*, 550 F.2d 1294, 1300 (2d Cir.1977).

Clearly, there has been no allegation and no fact asserted to suggest that Morgan Stanley in any way associated itself with the activities of the individual defendants. There was no partic-

ipation by Morgan Stanley. Instead, all of Morgan Stanley's acts operated to deter the conspirators and make the accomplishment of their goal more difficult. Plaintiff has only alleged that Morgan Stanley was negligent or reckless in aiding and abetting. As noted above, no fact has been asserted that can constitute recklessness as a matter of law. Even if such an allegation were supported, such a state of mind would be inadequate along with inaction to constitute criminal aiding and abetting.

Even if a standard of civil derivative liability were adopted, which it is not, then Morgan Stanley still could not be derivatively civilly liable for anyone's acts in this case for the reasons stated above with respect to civil derivative liability for the underlying security counts.

Finally, plaintiff does not satisfy either the requirement that there can be an underlying pattern of racketeering activity or that there be an enterprise as required by Section 1962 with an independent economic existence from the pattern of racketeering activity.

The provisions of Section 1962(c) require two separate elements in addition to the elements of causality and an underlying pattern of racketeering activity. There must be an enterprise and there must be some nexus between the pattern of racketeering activity and the enterprise. In *United States* v. *Turkette*, 452 U.S. 576, 583, 101 S.Ct. 2524, 2528, 69 L.Ed.2d 246 (1980), the Supreme Court stated that:

> "The enterprise" is not "the pattern of racketeering activity"; it is an entity separate and apart from the pattern of activity in which it engages. The existence of an enterprise at all times remains a separate element which must be proved by the government.

Thus, the enterprise must have a separate economic existence from the pattern of racketeering activity. *Bennett* v. *Berg*, 685 F.2d 1053, 1060 (8th Cir.1982). The test for the essential relationship is defined in *United States* v. *Scotto*, 641

F.2d 47, 54 (2d Cir.1980), *cert. denied*, 452 U.S. 961, 101 S.Ct. 3109, 69 L.Ed.2d 971 (1981):

> One conducts the activities of an enterprise through a pattern of racketeering activity when (1) one is enabled to commit the predicate offenses *solely* by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of that enterprise. [Emphasis added.]

The plaintiff contended in open court that the enterprise in the RICO claim against Morgan Stanley is the group of Newman and his associates. This claim fails to meet the requirement of *Turkette, supra*, that the enterprise have independent economic significance from the pattern of racketeering activity. Under this analysis, Morgan Stanley's pattern of activity would be identical to the enterprise. As there is no other organization, or group or individual that could possibly satisfy the enterprise requirements, including the *Scotto* test, the plaintiff completely fails to make out this element of a RICO claim.

B.*Newman*.

Plaintiff's effort to state a claim against Newman is insufficient to warrant relief and withstand his motion to dismiss pursuant to Rule 12(b)(6). Plaintiff rests his argument that Newman is liable in treble damages for a violation of RICO on the mere fact that Newman has been convicted of violating some of the statutes listed in Section 1961. This assertion wholly distorts both the language of the statute and congressional intent in its enactment. As previously noted, RICO does not create a treble damage remedy for violations of the mail fraud statute. Nor does it create such a remedy whenever plaintiff alleges a violation of a Securities Act. Otherwise, the same allegations that the Supreme Court has held do not state a claim because of a failure to show a breach of duty to disclose, *Chiarella, supra*, or deception, *Santa Fe Industries* v. *Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977), or stand-

ing, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), or scienter, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), could give rise to an action for treble damages by the plaintiff's reference to the RICO statute.

Instead, Section 1964(c) is clear in its requirement that plaintiff's injury to be cognizable under RICO must flow from the RICO violation, not simply from the commission of an enumerated felony. RICO's civil remedy provision permits a recovery to any person injured in his business or property *by reason of a violation of Section 1962*, 18 U.S.C. § 1964(c) (emphasis supplied), that is, where the distinctive RICO felony caused plaintiff's injury, i.e., where the plaintiff suffered proximately a racketeering enterprise injury at the hands of the defendant. It is inadequate merely to assert that damages were caused by commission of the underlying felony acts. *Harper* v. *New Japan Securities*, 545 F.Supp. 1002 (C.D.Cal.1982). Plaintiff's alleged injury did not result from an enterprise created or supported by the fruits of a pattern of racketeering, from an enterprise controlled by racketeers, or from a pattern of racketeering activity carried on in association with an enterprise (prerequisites of Section 1962). Nor was the injury causally connected with a felony enumerated in Section 1961.

Plantiff's loss of an opportunity for additional profits stemmed from his decision to sell Deseret stock the day before a tender offer for this stock was announced by Warner Lambert. Plantiff's decision to sell was not induced by any act of the defendants. The subsequent rise in the price of Deseret stock was the consequence of Warner Lambert's tender offer, which occurred subsequent to the sale. The plantiff's sale was not timed by any act of the defendants. Even if the on-going accumulation of funds by Newman, Courtois and Antoniu enabled them to purchase Deseret stock, this undisclosed activity in no way restrained or catalyzed the plaintiff's decision to sell his stock shortly before the announcement of a price increace.

Thus, as plaintiff has not alleged any injury that flowed from a violation of Section 1962, as required by the statute, the motion of defendant Newman to dismiss the RICO count must be granted.

Summary Judgment is Appropriate here.

Plantiff has correctly argued that the well-pleaded allegations of the complaint must be accepted as true and all reasonable inferences flowing therefrom must be construed in favor of the plaintiff on the motion pursuant to Rule 12(b)(6). It is also true that the motion for summary judgment may be granted if, as appears here, the record demonstrates that there are no genuine issues of material fact to be tried [2] As a diversionary statement, plaintiff suggests that it has not yet had an opportunity to pursue the necessary discovery to develop its claims against Morgan Stanley. Plaintiff mentions a possible exploration of the reasonableness of Morgan Stanley's "security program and its possible awareness of the long-lived scheme of its employees." Finally, plaintiff argues that it is not bound by the view of government in the criminal case that Morgan Stanley was a "victim" of the scheme.

Plaintiff may not escape his obligation to go forward with any actually needed discovery with which to meet a motion for summary judgment. Plaintiff was duly tendered but waived such discovery, if indeed there was any useful purpose to be served by it. No claim to such a need was voiced at the hearing of the motion.

On September 21,1982, two and one-half months before the return date of the motions, the parties met with the Court at a pre-trial conference. It was then agreed that the motion for summary judgment to bring to a head the question of the existence of genuine litigable issues would be made and that

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[2] Once the Court decides to accept matters outside the pleading, it must convert the Rule 12(b)(6) motion to dismiss into one for summary judgment. Wright and Miller, *Federal Practice and Procedure*, § 1366, p. 679, n. 66.

before hearing the plaintiff would be afforded whatever discovery plaintiff deemed necessary to defend the amended complaint. Immediate documentary discovery was provided by Morgan Stanley and no additional documentation was requested. Plaintiff was asked—repeatedly—and their requests were confirmed on October 1, 1982, two months ago, to designate any witness or witnesses connected with Morgan Stanley for deposition. No request for any deposition of anyone was made by the plaintiff. Indeed, the plaintiff did not even respond to the defendant's offers of witnesses. It is a fair inference in the circumstances on the basis of the affidavits submitted by Morgan Stanley and their challenging effect and the background of this case that discovery would demonstrate cogently the absence rather than the presence of genuine issues of material fact on either the securities claim or the RICO claim.

No law can be cited which warrants denial of summary judgment simply because the plaintiff has deliberately failed to conduct discovery.

The Court is amply justified in finding and concludes that plaintiff has declined the opportunity to depose Morgan Stanley and has chosen instead to stand on the unsupported allegations of the amended complaint, claiming that these allegations and the "questions" plaintiff's counsel now raises are enough to preclude summary judgment.

Rule 56(e) of the Federal Rules of Civil Procedure provides that:

> When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegatioins or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him.

When these sentences were added to Rule 56 in 1963, the Advisory Committee noted that:

> The very mission of the summary judgment procedure is to pierce the pleadings and to assess the proof in order to see whether there is a genuine need for trial.

Advisory Committee Note, Proposed Amendments to Rules of Civil Procedure for the United States District Courts, 31 F.R.D. 648-49 (1962).

As Judge Friendly has stated:

> When the movant comes forward with facts showing that his adversary's case is baseless, the opponent cannot rest on the allegations of the complaint but must adduce factual material which raises a substantial question of the veracity or completeness of the movant's showing or presents countervailing facts.

Beal v. *Lindsay*, 468 F.2d 287, 291 (2d Cir.1972). *See also, Schneider* v. *McKesson & Robbins, Inc.*, 254 F.2d 827, 831 (2d Cir.1958). The law in this Circuit is clear that even where there are allegations of fraud, "summary judgment cannot be defeated by the vague hope that something may turn up at trial." *Perma Research & Development Co.* v. *The Singer Company*, 410 F.2d 572, 578 (2d Cir.1969).

There is no reason why in this case the Rules which fully warrant an adjudication as to all defendants should not be applied.

The amended complaint is dismissed and judgment is to be entered in favor of the defendants against the plaintiff, with costs.